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Working Paper

The Eastward Enlargement of the Eurozone : The Shaping of Capital Markets Regional Inputs on Data and Statistic

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The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets
Regional Inputs on Data and Statistic

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The Eastward Enlargement of the Eurozone

Berlin Evora Helsinki Ljubljana Bologna Tartu Warsaw

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August 2002

The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets – Regional Inputs on Data and Statistic

Keywords : Capital Markets, Transition Economies, EMU

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REGIONAL INPUT: CAPITAL MARKETS IN BENELUX, FRANCE, AND GERMANY

THOMAS MEYER*

1 Overview

The introduction of the euro is about to change capital markets in the applicant states as well as in the current eurozone. This paper tries to reflect recent developments in some of the eurozone's core countries, its two biggest economies, France and Germany, and Belgium, Luxemburg, and the Netherlands.

External finance has gained much prominence in continental Europe. During the 90s, the amounts of outstanding stocks, private credit and bonds have soared in mature European economies (see Table 1). This has coincided with a number of developments – for instance, German unification, the completion of capital mobility, liberalisation and privatisation of big public utilities, most notably the telecom sector, the dot.com-bubble, the return of fiscal austerity as the economic policy of choice, and so forth. However, European Monetary Unification (EMU) has its stake, too. Capital market integration, brought forward by the euro, has enabled the placement of debt securities in new dimensions; necessary not only to buy fancy gadgets such as UMTS-licenses, but also to finance mergers and takeovers needed in order to consolidate corporate Europe.

Table 1: Key figures 1990 – 1999, 2001

		Belgium	France	Germany	Netherlands	USA
Domestic credit provided by banking sector (%GDP)	**1990**	70,3	104,4	105,4	103,0	110,9
	1999	147,3	102,2	145,2	126,8	164,2
Stock market capitalisation (%GDP)	**1990**	33,1	25,9	22,2	40,5	53,4
	1999	74,5	103,0	67,8	176,6	181,8
International debt securities outstanding (bn US$)	**1993/12**	32,5	149,0	118,7	52,0	175,7
	2001/9	128,9	384,9	993,8	315,5	2124,6

Source: World Development Indicators 2001, Bank for International Settlements 2002

Banks have expanded domestic credit in all European countries under scrutiny, except France with a minor decline. The raise has been strong in Germany, but especially strong in Belgium where domestic credit in relation to GDP more than doubled within a decade. The US serve as a

* I thank Jochen Blessing and Algara Stenzel who did the work; errors are mine.

reference and experienced also a strong increase in domestic credit by the banking sector, though the ongoing easing of Glass-Steagall might have helped.

Stock market capitalisation has doubled in Belgium, tripled in Germany and the US, and quadrupled in the Netherlands and France. Germany and France started at rather similar, low levels back in 1990, but in 1999 stock market capitalisation in France exceeded Germany's by one third, which may compensate the stagnation in credit expansion.

The amount of international debt securities outstanding shows remarkable increase: The values at the end of 1993 have multiplied by 2001 in some cases reached nearly (Germany) or even beyond (USA) ten times their initial level-though the amounts are stated here in absolute US$-terms and cannot be compared directly with the former two categories.

Legislation tries to keep pace with the figures in Table 1. Good regulation is more and more an important factor in international competition. A number of laws and private (compliance) rules have been passed to establish a level playing field and to adjust to international, mainly Anglo-Saxon, standards. Given the nature of the European Union, progress is sometimes quite cumbersome – confer, for instance, the failure to create a European takeover procedure. But market forces will continue to lobby forward good regulation and sanction delay.

The financial industry undergoes rapid changes, too. Though market sizes have soared, competition has increased as well, squeezing margins and promoting consolidation. Europe's segmented financial markets need to integrate if they are to generate economies of scale on a level comparable to their international competitors, such as NYSE and TSE. Consolidation among European stock exchanges is palpable, but there is a lot of political clout that seeks to protect domestic financial centres. Thus, integration seems to take rather the form of increased cooperation in trading and clearing instead of real concentration and specialisation.

Firms in Europe can draw on a bigger range of financial instruments at more market places – lowering in general costs of capital. However, competition for funds has increased, too: with more options available, lenders become picky as well. Especially in Germany, where many firms enjoyed preferential conditions, more price discrimination-ie, low interest rates for good risks and vice versa-is incrementally applied and should lead to a more efficient allocation of funds. Sure enough, this is at the same time a removal of old-established subsidies to German firms in favour of other European corporate borrowers. Anyway, the European capital market(s) will become a mighty force for corporate fate.

2 Financial Integration

2.1 Banks

Continental Europe has a bank-based system. Banks still play the dominant role in collecting savings and providing credit. However, as every spoiled child, banks in France and Germany are no champions with regard to market share and profitability. The private banking industry in Germany holds only a quarter of the domestic banking market and profits of German banks are lowest in Europe. Second-worst are French banks (Economist, 1999). The main reason lies with public intervention: Germany's microfinance institutions of the 18th century, Sparkassen and Genossenschaftsbanken, though outlived in concept, still hold a major share of the market. Public-sector banks enjoy a very explicit state guarantee that makes it cheaper for them to raise money and gives a competitive edge in front of private banks. Moreover, public banks sometimes enter business that privates would abstain from, because risks are too high or margins too small. The taxpayer settles the bill, such as the $2bn the City of Berlin had to inject in order to rescue its failing Bankgesellschaft (take Crédit Lyonnais a for French example). However, the reason why public-banks shoulder sometimes extraordinary exposures not only state protection but also state influence, that forces them into some business. Supervisory boards are dominated by politicians who may urge the bank to finance for political rather than economic reasons. Loans of the Bavarian Landesbank to the ailing Kirch group, a Bavarian media company and would-be mogul, may be an example. Europe is overbanked, with twice as many branches per head than America. The market is segmented between some big private banks and a myriad of smaller and bigger public-sector banks, where the privates only hold a minor share. This leaves the European banking sector less efficient:

Table 2.1: Interest rate spread (lending minus deposit rate percentage points)

	Germany	France	Belgium	Netherlands	Luxembourg	USA
1990	4,5	6,1	6,9	8,4	-	1,9
1999	6,4	3,7	4,3	0,7	-	2,7

Source: World Development Indicators, 2001

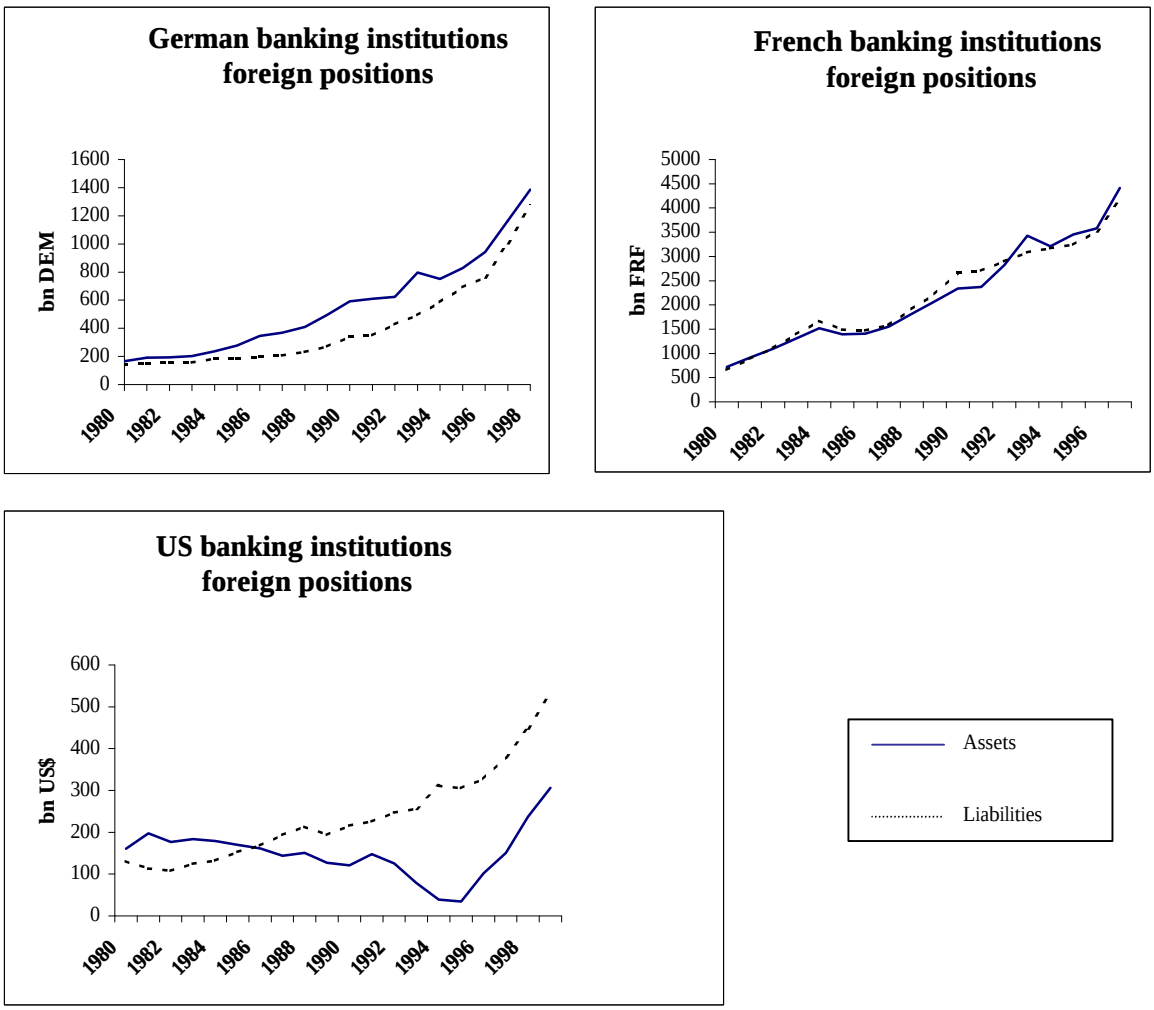
The picture is uneven. France, Belgium, and the Netherlands had their interest rate spread reduced, in the case of the Netherlands by nearly eight percentage points, whereas Germany experienced a rise from 4,5 to 6,4 percentage points. At least the direction is the same as in the US where the spread rose from 1,9 to 2,7 percentage points. However, European spreads remain at least one percentage point higher than in the US (except for the Netherlands, whose astonishingly low level deserves some closer look). The meaning of these figures is not self-

evident. Low spreads may indicate high competition and efficiency of financial intermediation-ie, low operating cost. However, they can also be influenced by public subsidies, such as state guarantees which push down spreads. Moreover, the difference between raising and lending money does also depends on borrower's risks. A rising spread could, thus, indicate an increase in default probability-either, because business has become more risky in general, or lending has more and more focused on riskier borrowers. Low risk clients, such as blue chip companies, might have turned directly toward capital markets-eg, by issuing own corporate securities-leaving banks with a portfeuille of higher risks. If that would be the case, higher spreads may even point to an efficient banking industry, because credit rationing-ie, lower spreads and lower volumes-seem less an issue. But again, the data so far allow no clear assessment.

Despite the interest rate spreads, margins in retail and wholesale banking are smaller on the continent than elsewhere. Profitable investment banking is dominated by Anglo-Saxon institutions that are tough competitors. The introduction of the euro deprives banks of some $25bn in revenues of currency transactions (Economist, 1999). The answer of most European banks is to consolidate-ie, to merge with other European or international banks to reach a seize that allows to compete in a global financial market. In Germany alone the number of banks shrank by 281 between 1998 and 1999, mainly Sparkassen and Genossenschaftsbanken, that seek to merge to bigger units (Deutsche Bundesbank, 2000). On the international scene, Deutsche Bank, Germany's biggest, successfully bid for Bankers Trust in the US and unsuccessfully for Crédit Lyonnais, which French authorities did not allow to fall into foreign hands. Le Banque Nationale de Paris bid for Société Générale and Paribas (Economist, 1999). Another big merger between Deutsche and Dresdner Bank, both than heavily connected to Allianz, a German insurance company, failed.

Banking goes international. With the euro's introduction, foreign positions of banking institutions in the eurozone have shown a remarkable increase: foreign assets have risen from €1579bn (1998) to €1703bn (1999); foreign liabilities from €1373bn to even €1775bn (IMF, 2001). Figure 2 display the dynamic in Germany, France, and the US:

Figure 2.1: Foreign positions of banking institutions



Source: International Monetary Fund, 2001

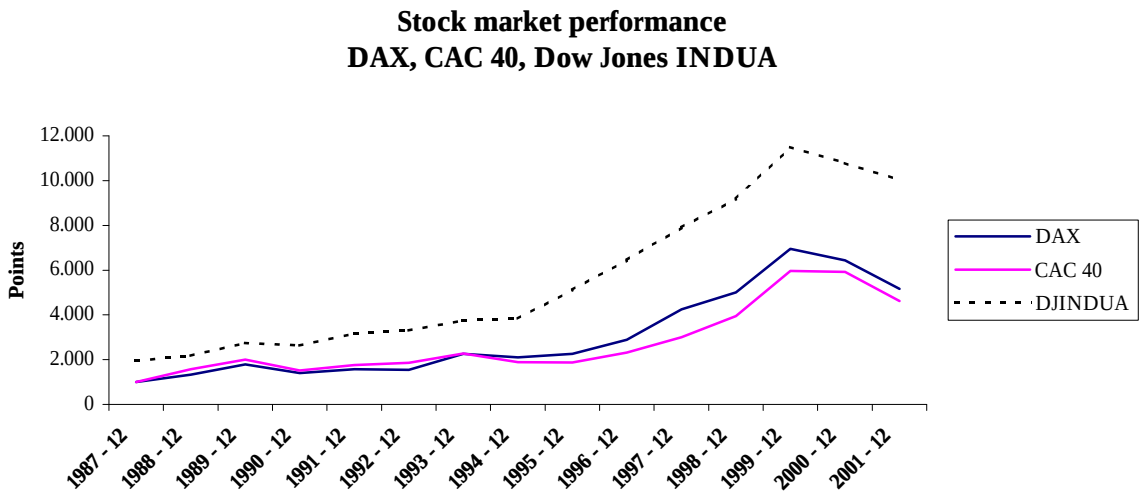
Smaller domestic markets in Europe have forced banks early on to seek international business. Hence, the much higher figures in Europe as opposed to the US. The late 90s show an exponential increase in foreign position in all three countries, which indicates the growing importance of international strategies in banking.

2.2 Equity

Stocks have become popular in Europe, though some enthusiasm turned sour after the burst of the dot.com-bubble. Shares are now much wider held than a decade ago: Investments in equity have been the resort of the wealthier whereas middle-incomes and below have preferred risk-free savings-account. This has changed. Many savings are now channelled to equity-mainly via mutual funds, distributed by wholesale and retail banks-in order to participate in the strong stock market performance 1995-2000, and because private pension schemes are on the rise: The number of

shareholders in Germany has risen from 700k in 1997 to nearly 1,3m in 2001-market capitalisation has had its peak in booming 1999 with €1400bn and dropped to €1200bn in 2001, indicating both, that shareholders have not been discouraged by the current baisse-and thus have not only been lured in by the dot.com-frenzy-and that individual holdings are shrinking (IWD, 2002).

Figure 2.2:



Sources: Deutsche Börse, 2002; Euronext Paris SA, 2002; Commodity Systems, Inc. 2002

Share prices shall reflect discounted future dividends-ie, expected profits related to the associated risk. However, share prices also reflect the liquidity in the market, but liquidity driven quotes may not be an appropriate indicator for corporate performance. Volatile liquidity adds to bid-ask spreads-ie, trading costs-and, thus, render equity less attractive. European firms have discovered equity as a necessary source of financing and have been worrying where to yield the best prices for their shares. Stock exchanges in Europe are trying to succeed the current fragmentation while policy-makers try to preserve the regional financial centres and jobs in Frankfurt, Paris, etc. Table 3 provides an overview on European stock markets in comparison to the US

Table 2.2: Stock markets – Key indicators 1999, 1998

Country	Market capitalisation (% GDP)	Turnover ratio (value % capitalisation)	Number of listed domestic Companies	Trading costs (basis points) 1998		
				Explicit	Market impact	Total
Belgium	74,5	27,5	172	25,59	9,23	34,82
France	103,0	62,4	968	22,76	7,10	29,85
Germany	67,8	107,5	933	24,45	14,59	39,04
Netherlands	176,6	145,1	344	22,99	22,07	45,06
USA*	181,8	123,5	7651	13,36	17,53	30,89

***Trading costs refer to NYSE

Sources: World Development Indicators, 2001; Domowitz et al. 1999

European stock markets are much smaller and less lively than in the US. Trading costs and in particular explicit trading costs-ie, fees and commissions-are in general higher, reflecting European fragmentation. The result is increasing European collaboration and mergers between stock exchanges: Amsterdam, Brussels, and Paris have formed Euronext in 2000, and subsequently took over London based LIFFE. The acquisition of London Stock Exchange by Deutsche Börse to form iX has failed so far. Electronic exchanges, such as Virt-X, try to combine economies of scale in blue-chips with the cost-efficiency of electronic trading.

The scramble for European consolidation is understandable, given that firms increasingly use the exit-option and list abroad. Nasdag and NYSE officials are on promotion in Europe to collect the dissatisfied: 18 French, 18 Dutch, and 14 German firms are already NYSE listed, with names such as Royal Dutch, Alcatel, DaimlerChrysler, and so forth, totalling a market capitalisation of $121,8bn, where the bulk-$76,3bn-belongs to Dutch firms, followed by France with $36bn and Germany with $9,4bn (NYSE, 2002). Nasdag has French LVMH, a producer of overpriced luxury-goods, and Dutch ASM as clients (Nasdag, 1999/2000).

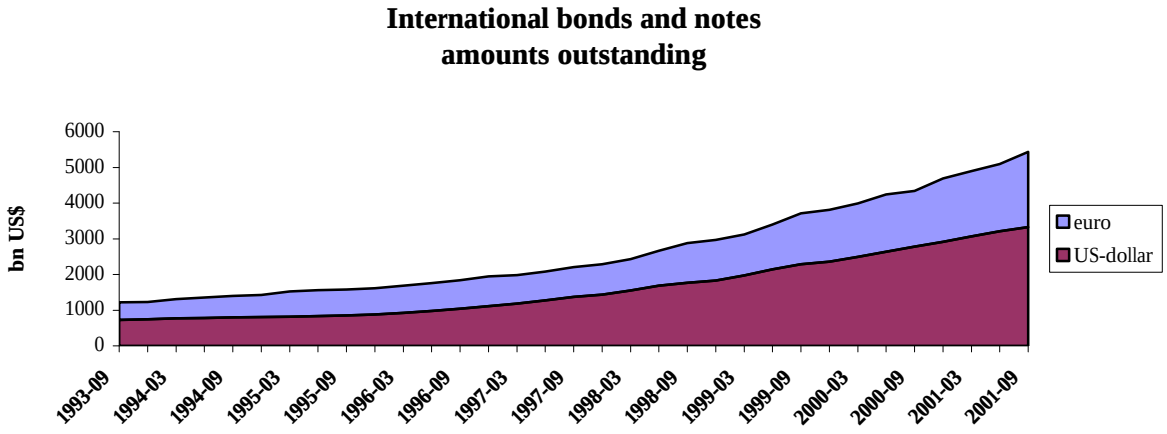
What's the euro's role in all this? Disentangling corporate ownership, probably. Germany is notorious for its corporate cross-holdings, where major companies own each other. Add to this the voting rights of banks-voting on behalf of customers that have shares deposited at the bank-and the label "Deutschland AG" becomes comprehensible. Though convenient for many business-leaders, this structure has proved to be an obstacle in international competition and an integrating capital market makes such disadvantages more apparent. Creation of shareholder value has become more prominent since more people own stocks and exit options-within and

outside Europe-have become cheaper. A further sign of this process is that a German middle-left government passed new legislation that generally facilitates takeovers, and gives the opportunity to squeeze minority shareholder out, as well as the abolition of a capital gains tax that allows to sell corporate holdings that otherwise would have remained with the owner in order to avoid taxes. The restructuring of corporate Germany is overdue but under way.

2.3 Fixed income

Bonds markets have been soaring in recent years. Though less glamorous than equity and with less influence than bank loans, their importance for capital market development can hardly be overstated. Given the comparatively weak position of bond-holders, a thriving bonds market is a leading indicator for the protection of property rights. Growth in euro and US-dollar denominated bonds has been strong in recent years:

Figure 2.3.1:



Source: Bank for International Settlements, 2002

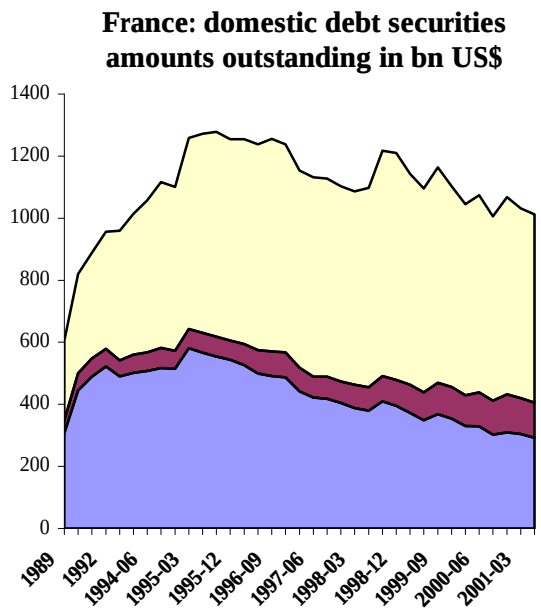
The amount in US$ terms of outstanding bonds and notes multiplied by 4,2 for euro-denominations (or predecessor currencies) and even 4,5 for US$-denominations. However, given the depreciation of the euro vis-à-vis the US$ since 1999, this picture even underestimates the dynamic in Europe.

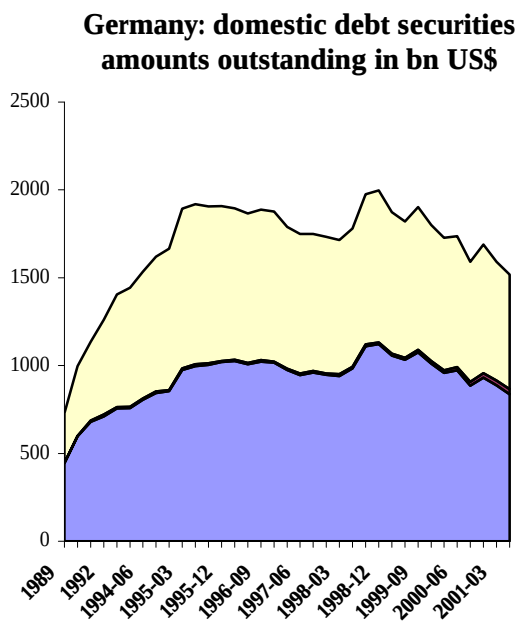
The composition of domestic European bond markets has changed, too. Figure 2.3.2 shows the development in important segments for the two biggest economies in the eurozone, France and Germany, in comparison with the US. Since 1989 market capitalisation in French and German domestic securities has surged with the peak at the beginning of 1999, coinciding with the start of

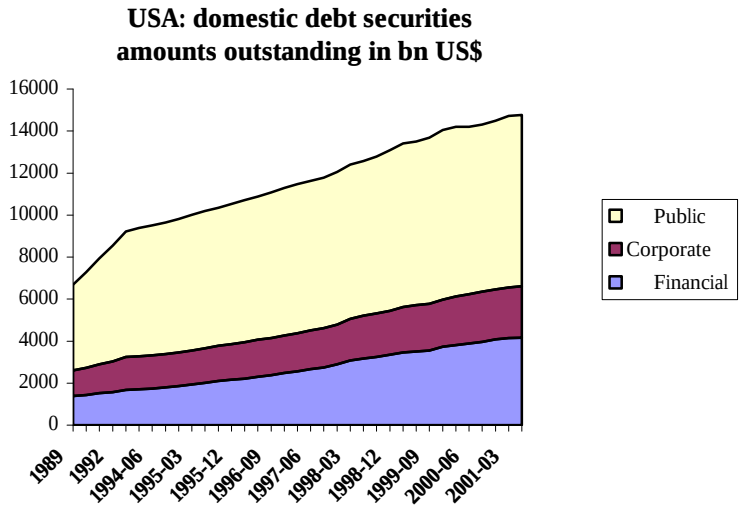
EMU. Since then capitalisation in US$ terms declined which can be attributed to the euro's depreciation. Important segments of the bond markets are public issues, still the biggest share in the US and France but not in Germany; bonds of financial institutions, which dominate Germany's market; and corporate bonds, which have the smallest part in all three countries but with very different dynamics.

Corporate bonds are of particular interest, because they represent the closest link between firm and capital market. Companies that issue debt securities are under close and unforgiving market scrutiny- "equity is a pillow, debt a sword" (Stewart and Glasssman, 1988)-which is suited to sanction any substantial deviation from value-maximisation (cf. Jensen and Meckling, 1976). Moreover, huge investment projects such as in the telecom sector and large scale acquisitions increasingly require external financing that efficient bonds markets provide. Finally, bonds allow to charge risk-adjusted cost of capital much easier than arms-length bank financing, which is too often locked-in to a hold-up position.

Figure 2.3.2:







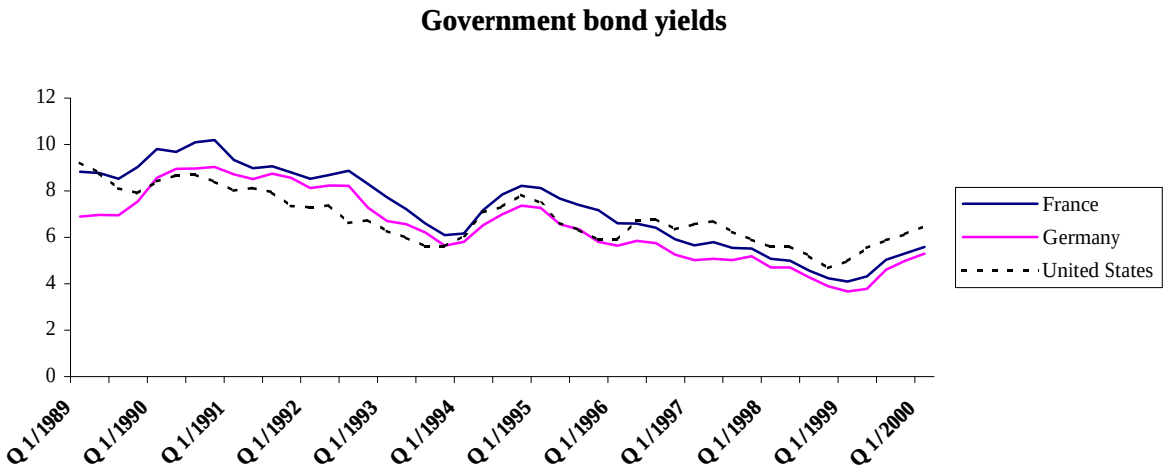
Source: Bank for International Settlement, 2002

Corporate bonds play only a minor role in Germany. You will need a magnifying glass to spot their share in figure 2.3.2 between public and financial issues. However, the dynamic has been most dramatic: Starting from a minuscule share of 0,1 percent in 1989 of all debt securities corporate bonds have reached a share of 1,9 percent by 2001-ie, a nearly twenty-fold increase. Since the euro's introduction the share tripled from a meagre 0,6 percent in 1999. France always had a stronger corporate bond share and showed a much weaker increase. Back in 1989 it had a share of 6,8 percent which increased to 11,2 percent in 2001 (in 1999 the share was 7,9 percent). With these figures, France has almost US-levels, which, dropping from a share of 18,2 percent in 1989-the peak of the LBO-frenzy-have now reached 16,6 percent. Given the increasing importance of banks in the US during the 90s (relaxation of Glass-Steagall) the risen share of financial institution's bonds comes to no surprise: 28,2 percent of all bonds are attributed to them now, compared to just 20,7 percent in 1989.

High-yield or junk bonds (those with a rating below investment grade) are still an exception in continental Europe as opposed to the US, where a strong recovery of the junk-bond market took place after the breakdown in the beginning of the 90s. European corporate bonds are mainly issued by blue-chip companies. The inexperience with riskier securities can be exemplified with the default of Fokker, a Dutch aerospace firm bought by German Daimler Benz. Some German banks had recommended these bonds to small private customers (and own employees) without sufficiently pointing to the inherent risk-in particular the non-liability of Daimler Benz-and had to pay hefty compensation afterwards (partly because British law did apply).

Synchronicity is what describes best the movement in public bond yields across France, Germany, and the US:

Figure 2.3.3:



Source: International Monetary Fund, 2000

The yield spread between French and German government bonds sunk from 194 base points in 1989 to around 30 base points since the second quarter of 1998-a time when creation of EMU seemed more certain than ever before. The remaining spread can be attributed to default and liquidity risks, where-thanks to its bigger market-Germany has still a slight advantage. Moreover, Germany has slightly higher ratings-Institutional Investor Credit Rating: 94,6 to 93,6; Euromoney Credit-Worthiness: 92,8 to 92,3; ICRG: 84,3 to 78,5 (WDI, 2001).

Integration within the eurozone can be observed along some figures. Thanks to the bigger European market, the average size of bond issues has increased. With the euro's introduction average corporate bonds issue value $400m, up from just $200m the year before. Government issues now seem to exceed a minimum of €5bn -€20bn if they aim for a benchmark issue . Moreover, investors are willing to acquire lower ratings: Issues with a Baa-rating grew by 529 percent during the period of 1996-98 as opposed to issues with an A-rating (122 percent) and AA-rating (55 percent). The introduction of features such as a pre-announced auction calendars; the use of EuroMTS, an liquidity enhancing technology; TARGET (Trans-European Automated Real-time-Gross Settlement Express Transfer System=ask this in an exam and drive your students mad) have helped to improve the efficiency of the European bond market. However, some impediments remain such as the lack of a uniformed bankruptcy law, different tax regimes (especially withholding tax), accounting conventions, and the fragmentation of settlement systems (ECB, 2000).

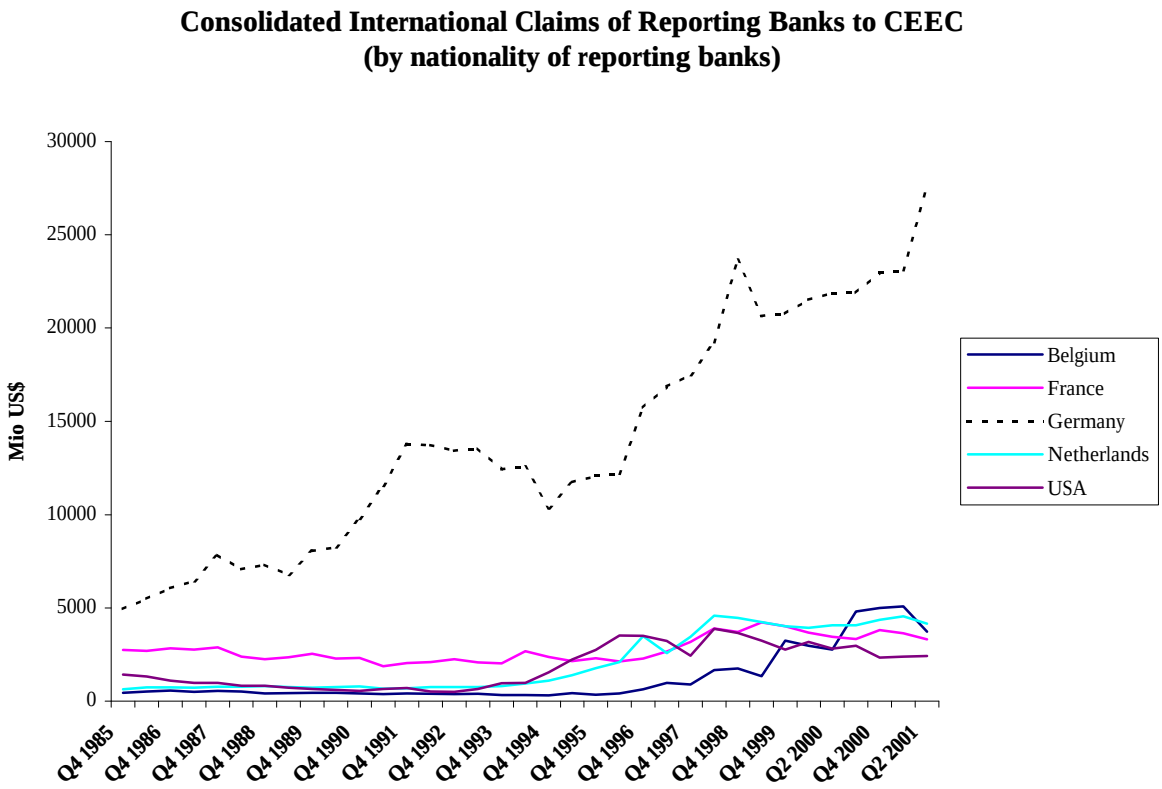
3 Convergence, capital flows and capital risk

Investments are needed if eastern European countries are to level with their western counterparts. Investment quotas in CEE-between 19 and 32 percent of GDP-are generally higher

than those in the current eurozone which are quite stable around 20 percent (WDI, 2001; ECB, 2002). Domestic savings are not sufficiently high, so that net foreign capital inflows are needed to make up for the difference which amount to roughly 4 to 7 percent of GDP (EBRD, 2001). Geographical proximity has made Germany early on a heavy investor in the region, with France and other euro-members and the US being less enthusiastic (see Figure 3.1).

The large exposure of German financial institutions to the CEEC implies at least to risks: (i) Shocks hitting CEE may affect Germany much stronger than other investing countries. However, the total amounts-eg, the $27bn claims of the banking system-do not look threatening for the economy as a whole. The regional distribution of claims within Germany might be of some concern-for instance the heavy losses of Bankgesellschaft Berlin in business with eastern Europe. (ii) The reliance on few countries as main investors may increase volatility of capital flows. The level of investment does not only depend on investment opportunities but also on financing conditions in, say, Germany. A German credit crunch could translate to the CEEC because it seems unlikely that other countries could fully substitute the German commitment.

Figure 3.1:

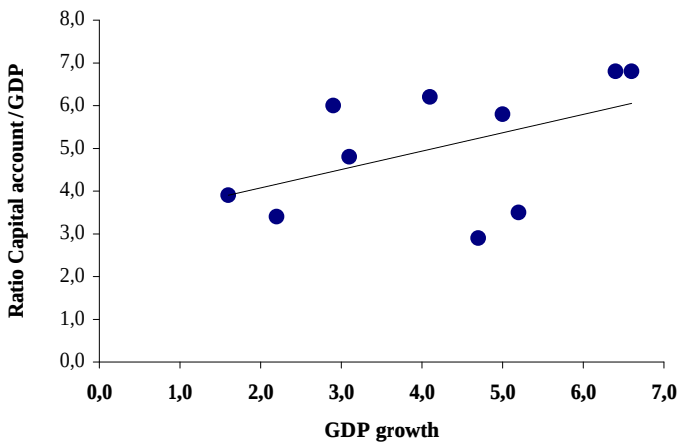


Source: Bank for International Settlements, 2002

Moreover capital flows are suspected to show a considerably pro-cyclical behaviour, and thus aggravate instead of mitigate economic volatility. This is the more true, the more capital flows depends on conditions other than domestic investment opportunities. Overinvestment, asset-price bubbles, and other forms of misallocation may be the consequence. Figure 3.2 relates capital inflows to GDP growth and displays the respective pairs of figures for all CEE applicant states. The picture does not self-evidently vitiate the consideration that a factor like GDP growth might be a stimulating force, thus, supporting the fear of pro-cyclical flows. Though, there is of course a connection between GDP growth and investment opportunities.

Figure 3.2.

GDP growth rates and capital account / GDP ratio in applicant states (2000)



Source: EBRD, 2001

4 Institutional framework

Differences in regulation are an often quoted impediment to capital market integration in Europe. Standards, practises, and law deviate from each other within the eurozone-and with regard to other financial centres, mainly London and the US. Particularities in domestic regulation can become a problem because they increase information costs of investors, which have to know and assess the differences, and may be rewarded by a discount on domestic asset prices. Hence, the current trend toward a unified regulation, respectively the attempts to explain the benefits of some particularities ("comply or explain"). On the EU-level some laws and directives have been passed that set standards for European capital markets. Table 4.1.1 summarises certain examples:

Table 4.1: EU financial legislation

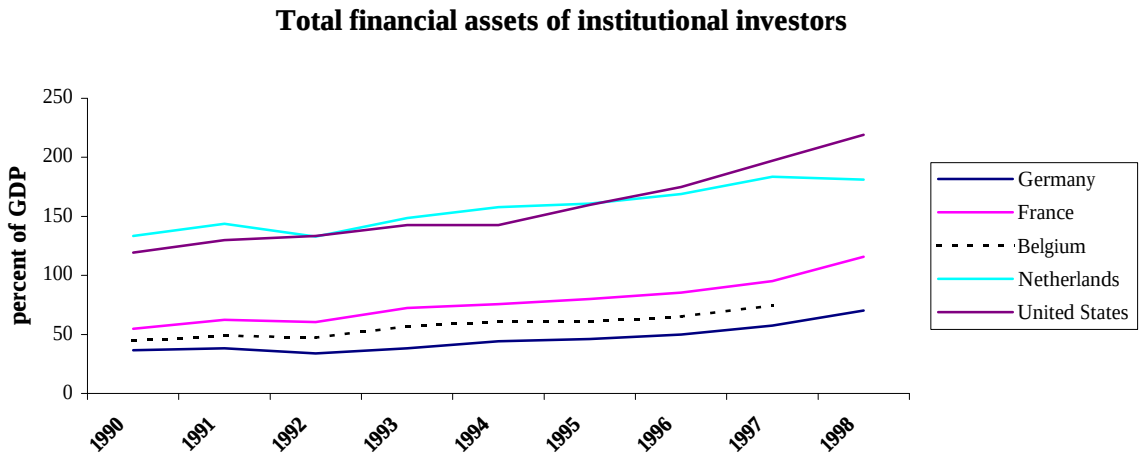
Capital Liberalisation Directive	• Removal of capital controls within the EU and most part of third countries (exception, that have been granted to Spain, Ireland, Portugal, Greece are less likely for CEEC)
Second Banking Directive	• Minimum capital requirements for new banks (€5m), principles of a single banking license and home country control • Any institute with home country license can establish branches elsewhere
First Banking Directive	• Common rules for granting licenses, basic principles of cooperation between supervisory authorities
Bank Account Directive	• Harmonises formant and content of annual accounts
Consolidation Supervision Directive	• Credit institutions must be supervised on a consolidated basis
Own Funds Directive	• Defines own funds
Solvency Ratio Directive	• Minimum risk-adjusted ration of own funds to total assets of 8 percent
Capital Adequacy Directive	• Supervisor may set minimum requirements for non-bank investment firms
Directive on Large Exposures	• Limit of 25 percent of own capital on lending to a group of related clients, limit of 800 percent of own funds on the total value of large exposures; large exposure is a single client exceeding 10 percent of the lending institution's own banks
Deposit Protection	• Deposit insurance up to €20 ,000 by credit institutions, deposit insurance shall not become an instrument of competition

Source: Wagner and Iakova, 2001

The quality of institutions are an important determinant of investment decisions. Members of the eurozone have felt the increasing pressure to modernise their financial regulation. In Germany, a new code on corporate governance has just (February 2002) been published, which is a good example. Though not a formal law, and thus no formal sanction in case of non-compliance, German firms may face a discount on the capital market if they deviate from this standard without an appropriate explanation. Hence, enforcement is given to the capital market, which may be more efficient than a public authority. Note, however, that it needed some public impulse to create the code in the first place.

Institutional investors are on the rise in Europe-and elsewhere (cf figure 4.1.). This is basically a good thing because institutional investors care for shareholder value, corporate governance, and have portfeuille-considerations in their investments. However, the problem of information-free riding and herding behaviour persists.

Figure 4.1.



Source: OECD, 2000

France and Germany with their pay-as-you-go pension schemes have substantially lower shares of institutional investors than the US, where big pension funds bloat the figures. Minor steps are undertaken to-at least-complement European-pension schemes with a private, capital-based feature, which should let the importance of institutional investors swell as well. Big funds are in a way limited in their investment decisions: They cannot rush in and out of particular stocks because-due to their size-they would distort prices. What remains, is to use the importance as a large shareholder for good performance (cf Hawley and Williams, 2000).

5 Conclusions

The euro adds economic clout to something that would take place anyway. Capital markets gain importance throughout continental Europe, and it seems that individuals, public authorities, firms have to adapt-not otherwise. Given, that markets are the more efficient way to allocate resources, there should be no reason for concern. Problems may arise, when the institutional frameworks fails to accommodate the process. A couple of conflicts can be identified:

(i) Capital markets tend to integrate and consolidate-ie, realise economies of scale. A first threat could be the fear of a monopoly in the sense of a unified exchange for stocks

and bonds as well as less competition in banking services, but given the international dimension, competition with the US and other economic centres, this seems unlikely-letting alone the fierce protection of local financial centres by European politicians. However, public intervention may pose a problem in itself, either that regulation and legislation does not keep pace with capital market dynamics, or that counter-productive incentives are set, for instance state guarantees, or alike.

(ii) The current development seems to favour big, blue-chip companies. Past implicit subsidies for smaller companies in capital raising-eg, less discriminating interest rates, listing costs below break-even-may vanish putting a strain on one of Europe's most dynamic sector. Though capital allocation is improved, transitory costs for SME may be a problem and provide a legitimacy for otherwise unwelcome public intervention.

(iii) A quickly changing capital market may prove to be destabilising. Inexperience and inconsistency may lead to overlending and asset-price bubbles even without public fault. The dot.com-bubble and Enron debacle are a reminder that financial systems do not work as smoothly as everybody wishes. The eastward enlargement of the eurozone lets European financial institutions seek new profits in CEE-which is risky. But hopefully, some lessons have been learned from the Asian-crisis, if only to allow to fail-even the national champions.

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REGIONAL INPUT: CAPITAL MARKETS IN PORTUGAL AND SPAIN

CARLOS VIEIRA AND ISABEL VIEIRA

1 Introduction

Financial markets around the world have been subject to innovation and restructuring waves that became especially strong in the last two decades of the twentieth century. This paper focuses on the transformations experienced by the Iberian markets. In the particular cases of Portugal and Spain, the main determinants underlying financial modernisation were the integration in the European Economic Community (EEC) in January 1986, the preparation for the 1992 Single European Market program, and the introduction of the euro in 2002. Promoted by these three events, processes of deregulation, globalisation, innovation, disintermediation and securitisation were progressively 'imported' from other more developed economies.

The restructuring of the Spanish financial system took place around one decade ahead of the Portuguese system. It began after the first oil shock in 1973, experiencing highs and lows at first, which were mainly a consequence of the public sector financing needs (Ontiveros and Valero, 1993). In the case of Portugal, the state of financial underdevelopment inherited from the dictatorship years was further extended in time by the processes of nationalisation of financial institutions in 1975. In both cases, however, it is generally accepted that, before entering the EEC, Iberian financial markets were heavily regulated and non-competitive (see, for instance, Macedo (1988) and Martinez (1988)).

The reforms that took place in the first years of EEC membership, and that were implemented with the objective of future participation in a unified financial market by 1993, were of vital importance to bring Portuguese and Spanish financial markets to a level of development comparable to that of their European counterparts. Later, the introduction of the euro has also contributed significantly to reduce a number of legal, technical and even psychological barriers that were still segmenting capital markets all over Europe. In a currently more integrated financial area, borrowers have easier access to a wider investor base, and investors may accede to a larger range of financial instruments, which are available in a variety of locations.

Nevertheless, European capital markets did not all evolve at the same pace. In fact, the individual stages of development were quite distinct when the EEC was enlarged for the third time, and they are still different today, after the adoption of a single currency. In Portugal and in Spain, the liberalisation of capital movements and the participation in stage three of European Monetary Union (EMU) stimulated the development and integration of capital markets, encouraging an

increasing internationalisation of investment and financing decisions of resident sectors. In both cases this led to an accumulation of external assets and liabilities.

In the particular case of Spain, the rise of investment in external assets was mainly in the form of shares and other equity acquired by non-financial corporations, especially Spanish multinationals, and institutional investors. While until 1999 the main destination of these funds was Latin America, since 2000 the main receptor is the European Union (EU). In terms of liabilities, significant flows of capital have entered Spain via the acquisition of shares in Spanish companies.

In Portugal, the stock of financial assets in the hands of non-residents increased from 39% of GDP in 1998 to 51% of GDP in 1999. In Spain, since the introduction of the euro, national savings have been insufficient to finance the growth in investment, leading to a negative net balance due to the high level of external financing. The internationalisation of financial flows has enabled residents to achieve a more efficient diversification of their portfolios and sources of financing, but the growing external indebtedness of Portuguese and Spanish corporations and households also exposes them to new sources of risk.

2 Banking Sector

Until quite recently, the banking system was practically the only source of external financing for private and public non-financial enterprises in Portugal and in Spain. Before EEC integration, and in the first years immediately after, banks were heavily regulated and restrained in their activities. The amounts and the type of credit were limited, fees were centrally determined, and active and passive interest rates were established by monetary authorities in compliance with monetary policy's objectives and public sector's financial needs.

In 1986, no Portuguese or Spanish bank had the dimension or the structure that allowed it to successfully compete in an open context. In the end of the 80s, in order to overcome this problem, a number of bank mergers took place in Spain. Fiscal and political incentives were behind this wave of banking concentration. In Portugal the process started later, since private banking was allowed only in 1985, the date when interest rates' liberalisation was initiated. Nevertheless, some interest rates continued to be centrally determined until 1992. By then, both countries had change to an indirect monetary control, in accordance to EEC requirements.

In the years immediately preceding EMU, the process of nominal convergence led to a significant drop in interest rates (table 1), interpreted as irreversible by the economic agents, with an acceleration of domestic consumption and negative effects on the external accounts. Both Portuguese and Spanish banking systems expanded credit (table 2), obtaining funds in the external euro market, now more accessible given the disappearance of foreign exchange rate risk, and, especially in the case of Portugal, a more positive evaluation by foreign banks of the financial strengths of their Portuguese counterparts.

Table 1: Interest rate spreads in Portugal

	1995	1996	1997	1998	1999	2000
Loans and other credits, 91-180 days	12.7	11.0	8.4	6.0	5.1	6.4
Deposits, 181 days – 1 year	8.1	5.4	4.1	2.8	2.4	3.5
Spread	4.6	5.6	4.3	3.2	2.7	2.9

Source: Banco de Portugal, Relatório do Conselho de Administração

Table 2: Total internal credit (homologous change rate) in Portugal

1996	1997	1998	1999	2000
12.6	11.6	16.8	19.9	24.4

Source: Banco de Portugal, Relatório do Conselho de Administração

Household debt in Portugal rose from 20% of disposable income in 1990 to 88.4% in 2000. Corporate debt rose to 83% of GDP in 2000. As a consequence, Portugal's International Investment Position (IIP) rose from 9.6% of GDP in 1996 to 28.3% in 1999 and 35% in 2000. This unsustainable trend has been recently corrected. The negative trend in interest rates has reversed, the growth rate of domestic consumption and private debt drop, and the households savings' rate increased. This, together with the recent increase in the capital of banks, eased the pressure for external financing.

The inflow of funds to Portuguese banks from non-resident banks reached 6.8% of GDP in 1999 and 10.5% of GDP in 2000. However, a significant part of these flows involved branches of domestic banks abroad, which have channelled to Portugal funds obtained by issuing bonds in the international capital markets. Consequently, the consolidated accounts of the Portuguese banking system do not show a strong increase in foreign liabilities, contrary to what a simple analysis of the balance of payments' flows would suggest.

The third stage of EMU promoted a number of structural changes in the European banking sector, which were also observable in the Iberian countries. Although, as mentioned above, the tendency to concentrate had already started, it was then further reinforced by a number of important mergers, acquisitions and strategic alliances. In the case of Portugal, the figures presented in table 3 indicate that the total number of institutions has been relatively stable. Nevertheless, a significant number of entries and exits were registered in these years, leading to a considerable increase in concentration. At the moment, the two major banking groups represent

a market share of around 50%. Moreover, the process of disintermediation of financial services led to financial groups integrating all domains of financial activity, such as banking, insurance, asset management and brokerage.

Table 3: Number of Portuguese banks

	Total	Non-resident
1996	50	19
1997	58	23
1998	58	26
1999	62	29
2000	62	33

Source: Banco de Portugal, Relatório do Conselho de Administração

Table 4 shows the continuous increase in the Portuguese banking sector's foreign position in the last years. In Spain, this phenomenon is especially visible in 2000, with the sum of asset and liability transactions of resident financial institutions with the external sector rising from 12.4% of GDP in 1999 to 20.9% in 2000.

Table 4 : Banking sector foreign position in Portugal (% total assets)

	1995	1996	1997	1998	1999	2000
Credits on non-resident credit institutions and clients	18.3	18.4	19.2	18.2	14.0	14.7
Resources from non-resident credit institutions and clients	21.4	23.7	25.6	27.1	24.7	29.4

Source: Banco de Portugal, Relatório do Conselho de Administração

The market share of non-resident banks in Portugal (Table 5) has been increasing in the last few years, and especially in 2000 due to acquisitions from a Spanish financial group.

Table 5: Market share of non-resident banks in Portugal

	1995	1996	1997	1998	1999	2000
Credits to clients	8.0	7.6	8.3	8.8	11.2	17.9
Assets	8.4	7.6	11.7	11.6	12.8	20.6

Source: Banco de Portugal, Relatório do Conselho de Administração

Stage three of EMU had important effects upon the interbank financing of institutions. EMU has provided greater facilities for the centralisation of the liquidity operations of euro area institutions. Foreign banks in Spain, for example, have replaced their traditional debit position in the domestic interbank market with foreign financing, probably from their parent institutions.

3 Equity Markets

In the beginning of the 80s, the state of equity markets in both Portugal and Spain may be characterised as archaic. Stock Exchanges were illiquid and very thin, with only a small number of national companies listed. Both primary and secondary markets were underdeveloped, had no proper regulations to guarantee efficiency, transparency or investors' protection. In Portugal, the Stock Exchange was closed in 1974, after the revolution, and reopened in 1976. However, from 1976 to 1982 only bonds could be traded. The *status quo* was changed in both countries with the preparations for EEC admission.

In more recent years, Portuguese and Spanish equity markets increased in size and activity, as can be observed in tables 6 and 7. Nevertheless, they continue to play a limited role in channelling financial flows. Table 6 contains information relative to the values of stock market capitalisation in Spain and Portugal. The figures displayed, and especially the Portuguese, are clearly below those of other European countries with established traditions in capital markets.

Table 6: Stock market capitalisation (% of GDP)

	Portugal	Spain
1997	38	53
1998	54	65
1999	63	76
2000	58	89

Source: Banco de Portugal, Relatório do Conselho de Administração

In 1999, total transactions of both stocks and bonds have decreased in the Portuguese Stock Exchanges. This may be partly due to a slower dynamics of the privatisation process, but also to lower demand of domestic assets by residents in general, and by Portuguese investment funds in particular. In fact, the introduction of the euro led to portfolio restructuring which appears to have favoured international assets.

Table 7: Transactions, Portugal (EUR millions)

1996	1997	1998	1999	2000
11 033	20 434	46 618	39 162	59235

Source: Banco de Portugal, Relatório do Conselho de Administração

The euro prompted the increasing internationalisation and integration of European equity markets. As a consequence, the two Iberian markets became more vulnerable to international financial fluctuations.

The values of the correlation coefficient between two Stock Exchange's indices are good instruments to ascertain their level of integration. Tables 8a and 8b present correlation coefficients for several European indices and for the Dow Jones Euro Stoxx 50, which represents the euro area. The rise in correlation is evident between the two periods, suggesting the increase of common factors to explain market behaviour. This is especially noted in Portugal, with a clear convergence to the euro area, although the Spanish markets appear to be significantly more integrated with the other European stock exchanges.

Table 8a: Correlation coefficients between weekly variations of stock exchange indices, 1993-96

	PSI20	MADX	FTSE100	CAC40	DAX	MIB30	Stoxx50
PSI20, Portugal	1.00						
MADX, Spain	0.34	1.00					
FTSE100, UK	0.20	0.51	1.00				
CAC40, France	0.25	0.59	0.62	1.00			
DAX, Germany	0.26	0.52	0.59	0.63	1.00		
MIB30, Italy	0.11	0.43	0.39	0.49	0.45	1.00	
DJ Euro Stoxx 50, EU	0.30	0.70	0.74	0.86	0.85	0.63	1.00

Source: Banco de Portugal, Relatório do Conselho de Administração

Table 8b: Correlation coefficients between weekly variations of stock exchange indices, 1997-00

	PSI20	MADX	FTSE100	CAC40	DAX	MIB30	Stoxx50
PSI20, Portugal	1.00						
MADX, Spain	0.71	1.00					
FTSE100, UK	0.55	0.68	1.00				
CAC40, France	0.65	0.76	0.74	1.00			
DAX, Germany	0.64	0.75	0.71	0.83	1.00		
MIB30, Italy	0.62	0.76	0.62	0.75	0.72	1.00	
DJ Euro Stoxx 50, EU	0.68	0.84	0.79	0.93	0.92	0.81	1.00

Source: Banco de Portugal, Relatório do Conselho de Administração

As in most international equity markets, the upward trend in share prices observed since the mid nineties was reversed in the Iberian markets in 2000, with a more pronounced fall in Spain - the Portuguese PSI20 fell 8.4% while the Spanish IBEX35 fell 21.7%. This fall might have been influenced by problems in the USA's new technologies markets, and may have been a consequence of growing internationalisation and integration.

The share in trading of non-resident investors in the Spanish stock markets rose from 47% in 1999 to 54% in 2000. In Portugal, at the end of 2000, portfolio investment of non-residents represented 27% of the stock market capitalisation. The entry of a Spanish financial group in the market in 2000 represented an increase of 31.8% in the stock market capitalisation.

The Portuguese stock market displays a high level of concentration, with the five most transacted stocks representing almost two thirds of the total volume of transactions. In the last years, the number of listed companies dropped considerably, as reflected in Table 9. Such tendency would soon create competitiveness and liquidity problems, and ultimately even threat the survival of the Portuguese Stock Exchanges. The chosen strategy to overcome these problems was the integration in the Euronext in January 2002.

Table 9: Number of listed companies in the Portuguese stock exchange

1996	1997	1998	1999	2000
158	148	135	125	110

Source: Banco de Portugal, Relatório do Conselho de Administração

4 Fixed Income

As mentioned before, Iberian financial markets were in past decades in a state of relative underdevelopment. Not all segments were however equally hampered, being the financial needs of the public sector the main determinant of the development level. In Spain, for instance, the short-term public debt market was modernised much earlier than the markets for longer maturities, and this tendency was also observed in Portugal.

In preparation for both the EEC entering and the 1992 Program, a number of regulations were introduced in both countries with the objective of creating flexibility and diversity in the fixed income markets. More recently, the introduction of the euro appears to have consolidated the level of financial integration of all members of the monetary union. In fact, a significant increase was lately registered in the proportion of bonds issued by EU member governments in the hands of non-residents. The disappearance of foreign exchange rate risk also motivated the demand for corporate bonds, leading to a general rearrangement in investors' portfolios, especially of those of investment funds.

In the case of Portugal, for example, bonds issued by non-residents have increased their importance in institutional investors' portfolios. On the other hand, public debt sold to non-residents almost doubled, from 4.4% of GDP in 1998 to 8.5% in 1999. The stock of public bonds in the hands of non-residents increased from 18.3% of GDP in 1998 to 25% in 1999. As a whole, the Portuguese financial sector increased the quantity of bonds issued in the international financial markets, reducing those issued domestically.

The spread of the long-run interest rate on public debt, to the German rates, increased in 2000 in Portugal and Spain, as well as in other European countries such as Belgium and Italy.

In Portugal and in Spain there was a decline in 2000 of the net issuance of domestic private fixed income markets, suggesting that the process of financial disintermediation has stopped, at least for the moment. In both countries, public debt still represents the majority of the total volume of transactions in the bond markets (77% in Portugal). In preparation for the euro, a new legal regime for the issuance and management of public debt was adopted in Portugal in 1998.

5 Institutional Changes

Financial stability, understood as markets', institutions' and prices' stability, is of major importance for monetary stability. The acknowledgement of this fact has led, in the last few years, to the reinforcement of the efforts to reform financial systems' regulations and supervision, both at the European and at the national level. However, this question may be less relevant for the Iberian economies, or even for Europe by comparison with the USA, since their financial structure is less dependent on markets, with banks still providing the highest share of financing of the economy.

In what concerns the Stock Exchanges, the internationalisation and integration trends following the adoption of the euro prompted legislation reforms, the introduction of new codes of practice, changes in the legal status of the entities managing the Stock Exchanges, and the introduction of new financial instruments and markets in both countries. Recently, a market for bond loans (1998) and a Special Market for Public Debt (MEDIP) in 2000 in Portugal and a market for high growth stocks (Nuevo Mercado) in Spain, also in 2000, for example. It also promoted several international agreements involving for instance settlement and trading platforms aiming at a liquidity increase - an example is the Euronext.

The process of privatisations continued in Portugal during 2000, involving a figure of 1050 million euros, which is twice the value of 1999, but half that of 1998. The major part of this value involved the privatisation of the only electricity supplier (EDP) and the national telecommunications corporation (Portugal Telecom).

Several changes have also occurred recently in the tax treatment of financial instruments. In what concerns the taxation of stocks' valorisation, both Portuguese and Spanish governments tried to balance the need for higher tax receipts, and tax justice, with the threat of capital outflows for European countries with more favourable tax conditions. Spain is planning to lower this tax rate in order to attract more international investors, while in Portugal the pressures from financial and non-financial large corporations have contributed to the cancellation of a tax increase and for the resignation of the Finance Minister in 2001. The recent change of government leaves some questions related to these issues still open.

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REGIONAL INPUT: CAPITAL MARKETS IN SLOVENIA AND HUNGARY

VLADIMIR LAVRAC

1 Slovenian banking sector

Slovenian financial sector is banking-dominated. Assets of the banking system represent more than 75% of the total assets of the Slovenian financial system (or more than 60%, if central bank's assets are excluded). Similarly, bank credit is by far the main source of external finance for business enterprises. In other words, banks are the leading financial intermediaries and prominent actors on the Slovenian financial market.

According to the FSAP (Financial sector assessment program) of the IMF and WB conducted in 2000, Slovenian banking sector has evolved in a sound and safe system with a strong capital base. It appears to be robust to external shocks and it does not pose a macroeconomic risk. A drawback is the fact that it evolved in a largely protected environment in which limited competition has inhibited consolidation and is still dominated by the largest banks which are controlled by the state.

At the end of 2000 (all data refer to end 2000, if not indicated otherwise) there were 25 banks operating in Slovenia. Alongside with banks, there were also 3 savings banks and 64 savings and loans undertakings, but they can be disregarded in the analysis, as banks hold 98% of total banking system's assets. Compared to end 1995, the number of banks has declined from 33 banks, 10 savings banks and 72 savings and loans undertakings operating at that period. Although some consolidation took place, banking system in Slovenia is still over-banked. The number of banks is too large for the small size of the Slovenian financial market, particularly taking into account forthcoming Slovenian integration in the EU and in the eurozone.

Of the operating 25 banks, 10 are fully domestically owned, 6 are in full or majority foreign ownership and remaining 9 are in (largely) prevailing domestic ownership. Banks in majority foreign ownership are relatively small in terms of market share (their combined market share is around 15%) and can not importantly affect developments in the Slovenian banking system. Overall ownership structure of the Slovenian banking sector by equity holdings is 37% central government, 51% other domestic entities and 12% non-residents. In fact, the so

far minor presence of foreign banks did not bring much competition to the Slovenian banking market (in terms of efficiency, diversity of products and quality of services). One could say that as free riders they rather "joined the system" and benefited from its inefficiencies.

In 2001 and 2002 acquisition of two of the larger banks by foreign banks took place, which should increase foreign ownership of Slovenian banks to more than 15%. This trend of increasing foreign ownership in the Slovenian banking sector will continue with the process of privatisation of the two largest banks which are now in majority state ownership. These two banks were nationalised in the process of their rehabilitation which took place in the period 1994-97. In May 2000 the government adopted the program of privatisation of both banks, which have a combined market share of above 40%. In the case of NLB, the largest bank, 34% of the shares would be sold to a key investor (possibly or very likely to a foreign bank), 14% to portfolio investors, while the state would retain 25% plus one share. In the case of NKBM, the second largest bank, 65% of the equity would be sold to a strategic investor (again very likely a foreign bank), while the state would again keep its 25% plus one share. At the time of this writing, the process of privatisation of these two banks is right underway, and if realised, it will result in a substantially increased foreign ownership in the Slovenian banking sector. Government's intention in the privatisation program is to consolidate ownership structure, to boost efficiency in the overall banking system by introducing more competitive environment, to comply with the EU requirements on the privatisation and opening up of the banking sector and to recover the cost of the banking rehabilitation process, reflected in the Slovenian public debt, as much as possible. Perhaps it would be interesting to note that in the process of privatisation a wave of national sentiment was raised in the public debate, claiming that prevailing domestic ownership of the largest banks is a matter of "national interest". It remains to be seen what the final outcome of the privatisation process of the Slovenian banking system will be.

Slovenian banking sector is rather concentrated. 3 largest banks have more than 50% and seven largest close to 75% of the market share. In recent years there was some consolidation in the banking sector, first by forming some banking groups and later by some mergers and acquisitions, mostly involving smaller banks. For some larger banks, some mergers were solemnly announced, but failed to materialise, mostly for personal and prestigious reasons.

Total assets of the banking sector are 3.192 billion SIT (Slovenian tolars) or 81% of the GDP. Total loans extended by the banking sector to the non-bank sector are 51% of total assets or around 40% of the GDP. Of the total credit extended around 60% goes to business firms, 30% to household and 10% to the government.

A measure of openness of the banking sector is its share of foreign assets (14%) in total assets and foreign liabilities (11%) in total liabilities, or, alternatively, its share of foreign denominated assets (33%) and liabilities (32%) in the balance sheet of the Slovenian banking system.

Capital adequacy (measured by capital/risk weighed assets) has been steadily falling in recent years (from say close to 20% in 1996), but with 13.6% end 2000 it is still comfortably above the required minimum capital adequacy of 8%. As far as the quality of the investment portfolio of the banks is concerned, bad assets (D and E classification) are at the level of 3.3% and non-performing (including C classification) are at the level of 5.2 of total assets.

In 2000, most (79%) of the gross income of the banking sector was earned from net interest income, which indicates that some more advanced financial products and services, particularly those related to investment banking, are only beginning to develop. Operating costs were at 55% of gross income or at 3.4% of total assets, while labour costs represented almost 60% of operating expenses (with 10.000 employed in the banking industry). It is interesting to note that almost half of the net interest income is due to revaluation (full indexation on the assets side, but not on the liabilities side). This means that profitability of Slovenian banks might decline once Slovenia succeeds in reducing the inflation rate from its presently high rate (around 8% annually), which makes the banking sector somehow "artificially" profitable.

Return of assets (ROA) is 1.1% and return on equity (ROA) is 11.3%. Net interest margin (defined as net interest income/gross interest-bearing assets) is currently at 4.5% and does not show much change in recent years. On the other hand, interest spread (difference between real interest rates charged on loans and paid on deposits of similar maturity) is currently 2.7% and has been constantly falling in recent years (from say 4.9% in 1997). If calculated as the difference between corresponding nominal interest rates, interest spread is

higher, 6.4%. Liquidity of the banking sector, if measured by the ratio of liquid assets to demand deposits, is 23.6%.

Finally, some strategic issues or forward-looking challenges in the development of the Slovenian banking system should be mentioned. Slovenia did not follow the example of some other transition countries (big-bang, shock therapy or eager reformers type), but preferred the gradualist approach to reforms, including to privatisation and opening to foreign capital (in general, and in the banking sector in particular). Slovenia for instance, did not rush to sell problematic banks early to foreign banks, but first rehabilitated them domestically. As the result, a substantial share of the ownership of the banks is still in domestic hands (and even in the hands of the state). Slovenian banking system will have to integrate into EU-wide banking system in the near future. The question is whether Slovenia can do it with its own banks, or they will be swallowed by larger European banks, like in other transition economies. If Slovenia decided for the former, it would have to first domestically consolidate their ownership structure and next expose them completely to foreign competition even before the accession to the EU. Due to the small market and lack of competition from other segments of the financial sector, domestic competition would not be enough to prepare Slovenian banks to survive on the EU-wide financial market.

2 Hungarian banking sector

Hungary has been at the forefront of financial sector reform and has one of the most developed (strongest and most stable) financial systems among the Central and Eastern European countries. Hungary early embarked on reforming the banking system. Banks have been restructured, recapitalised and privatised, mostly through sales to strong foreign strategic investors.

Although we are not in a position to give as detailed overview of the Hungarian banking system as in the case of the Slovenian one, where we have a local advantage, for the sake of comparison we present some rough figures on the Hungarian banking system as well. There are 34 commercial banks plus 8 specialised bank operating in Hungary. Together with 198 savings and loans cooperatives this adds up to 240 credit institutions operating in the banking sector. Total assets of the banking sector are close to 9.000 billion HUF (Hungarian florints), while those of commercial banks alone were slightly above 8.000 billion HUF (which is above

60% of the GDP). As far as concentration is concerned, 5 largest banks have 52% of the market share. Ownership structure of the Hungarian banking system is the following: state ownership is 21.3%, other residents 12.1% and non-residents 66.6% (50.8 foreign credit institutions).

Foreign assets represent 7.9% of the total assets, and foreign liabilities 17.1% of the total liabilities of the banking system. Extended credits represent 43.4% of total assets (of this, majority or 35.4% of total assets, goes to business enterprises, 5.9% to households and 2.1% to government). Capital adequacy ratio is at 13.9%. Non-performing loans in total assets can be estimated at around 3%.

Net interest income is close to 75% of the gross income, while operating costs are at 60% of gross income (with labour costs at roughly 1/3 of operating expenses). Return on assets (ROA) is 1.3% and return on equity (ROE) is 15.1%. Net interest margin is 3.9% and interest spread is 3.7%.

3 Capital market in Slovenia

It transition countries, development of capital markets does not necessarily reflect only the stage of progress in financial intermediation in the financial markets, but to a large extent also captures progress in transition and in particular in privatisation. Privatisation process, pension reform and legal environment have particularly influenced design and development of capital markets in transition economies. Development of the capital market should be seen both from historic perspective (privatisation process) and future perspective (integration into EU-wide capital market).

In Slovenia capital market development was mostly determined by privatisation process. In fact, we should rather speak of ownership transformation, because in Slovenia there was a dominant social ownership (a non-ownership concept). Therefore, privatisation was foremost elimination of social ownership or ownership transformation, rather than classical privatisation, elimination of state ownership. Most shares on the securities market in Slovenia originate from ownership transformation, and even secondary market is mostly a vehicle for ownership transformation. The main function of the capital market was to enable

abolishment of social ownership and later to seek for an adequate ownership structure (consolidation of ownership).

In recent years capital market in Slovenia has established itself as a viable component of the Slovenian financial system and as a complement to still largely prevailing banking sector. In contrast to its early years (early in the nineties) when securities market was limited to only a few bonds and shares, originating mostly from public offerings by financial institutions, the emergence of newly issued shares, related to ownership transformation, gave a push to capital market development in the later period (second half of the nineties). In the early years, bonds overwhelmingly dominated the market, with shares contributing only 5% to the turnover, while from 1996 on, shares dominate in trading on the securities market. Capital market reached its peak in 1998 (new issues, growth in market capitalisation, turnover and prices), while in 2000 it practically stagnated (increased market capitalisation, but stagnation in volume, indices). Taken altogether, in recent years there was a reasonable growth in securities market, but capital market still continues to be underdeveloped according to the EU (or Western in general) standards. Capital market did not operate in an open and internationally comparable (competitive) environment. A large part of its mission was of a transitional nature, dependent of ownership transformation. One could say that a more radical development of capital market in Slovenia was, first, somehow paralysed because of the characteristics of the Slovenian ownership transformation process (mass privatisation) and, second, restricted by the fact that it was never an explicit priority of the economic policy.

One of the characteristics of the Slovenian capital market is the particular role of the primary market, which is rather underdeveloped. Instead of its normal function to raise finance for issuers, mostly business firms, it is active only for government short-term and long term securities, while primary equity market for corporate shares practically does not exist. Non-financial companies in these circumstances can not issue shares to finance their development plan, but have to turn to banks for credit. One could say that primary market is poorly developed because it is suffocated by secondary market crowded with privatisation shares. High supply of privatisation shares, lack of large enough profitable firms, unelaborated technology of issuance, too high transactions costs and other factors inhibit development of primary market. Bond market lacks market conventions and standardised characteristics of securities, which makes investors' analysis more difficult and increases transactions costs. In these circumstances investment in corporate shares can hardly compete with banking deposits

or government bills or bonds, considering combination of risks and returns. Government, central bank and banks crowd out business firms, as they offer to investors relatively attractive and safe instruments. A more radical growth in the corporate shares' part of the primary market can realistically not be expected in the forthcoming years, but till the accession in the EU and EMU, primary market will remain an important source of financing for the government and the banks.

In Slovenia securities are traded on the organised market, which consists of stock exchange quotations (formerly A and B quotations) on the Ljubljana Stock Exchange (LJSE) and of the free or open market (OTC). Beside organised market, substantial trade in securities is conducted also in the off the market (grey market) part of the capital market. Technically speaking (trading system, progress in dematerialisation of securities and trading), LJSE is a very well organised securities market.

Secondary market is used mainly to consolidate ownership structure after the process of mass privatisation. Some of the characteristics of the market are its low liquidity (except for a few most traded securities), large amount of non-transparent off-market trading, high concentration of shares for the purpose of obtaining control in the privatised companies, large proportion of block trading, etc. Some of its inefficiencies are also due to the smallness of the market.

Main problems of secondary market are closely linked to mass privatisation. A large number of shareholders received their shares for free and want to sell them at first opportunity. Ownership transformation caused a chronical excess supply on the market, with its effect on market capitalisation, turnover, prices (indices) and liquidity on the market. Demand did not follow the supply, as foreigners, which might add to the demand on the market, were prevented in directly participating in (the first phase of mass) privatisation process, and later discouraged from entering the market by restrictions on foreign portfolio investment. Additionally, domestic institutional investors are not yet able to create a stable demand on the secondary market. Slovenian capital market is a relatively closed market not only because of regulation, but also because of its smallness and some privatisation peculiarities. Tax system has certain drawbacks, particularly unequal treatment of alternative forms of investments. Anyway, ownership consolidation process after mass privatisation must be completed before we can expect any further development of capital markets.

Impact of foreign investors' activity on Slovenian capital market was first felt in 1997. They contributed to increased demand, so that trading volumes and prices rose rapidly in that period, but the introduction of costly custodian accounts considerably reduced returns on short term portfolio investment, resulting in a significant drop of foreign portfolio investment in subsequent few years. After first relaxation and then elimination of short term foreign portfolio restrictions, foreign investors returned to the market after 2000.

With the opening and integration in the EU-wide capital market, domestic securities market may become marginalised. Institutional investors, even if they appear, will have to seek their investments largely in foreign markets. Small domestic investors will have an easier access to foreign exchange markets than now. The large and best performing corporations will consider listing their securities abroad. Foreign investors may find Slovenian market not interesting because of its smallness. LJSE will have to develop links and integrate in EU stock exchanges, i.e., become part of internationally organised securities market.

A specific and important feature of the Slovenian capital market are privatisation funds (PF or PID in Slovenian language). PF are Slovenian version of close-end investment funds (in fact, there are no other closed end investment funds). They were created in 1994 as part of the process of privatisation (elimination of social ownership) and given the role of privatisation intermediaries. They have some privatisation-related transitional features which are supposed to disappear gradually, so in time they will become normal financial institutions. Initially, PID sold their shares for ownership certificates (vouchers) and next they exchanged these certificates for shares of privatising companies. PF shares became transferable when they got listed on the stock exchange. PF still have a substantial part of unused certificates. Part of this is the consequence of privatisation gap, or a black hole, meaning that PF could not convert all certificates into companies' shares due to the shortage of available assets. Excluding unused certificates, large majority of their portfolio are corporate shares. However, most of their investment are illiquid or non-marketable companies' shares and concentration of ownership into individual issuers is strong (while normally portfolio of investment funds should be diversified and marketable).

Conversion of PF started in 2000. By mid 2002 they should have been transformed in either investment funds (close-end or open-end mutual funds) with diversified portfolio of tradable

securities or in holding companies, searching control over business enterprises - or partly in both, according to the nature of their investments. Ideally, they should aim at transforming into mutual funds, but the present structure of their assets does not allow it for the moment.

In the following some data on the development of capital market are presented:

Table 1: Some basic data on development of capital market in Slovenia

	End 95	End 96	End 97	End 98	End 99	End 2000
Market capitalisation (bn SIT)	110	178	399	628	795	967
Market capitalisation as % of GDP	5.0	6.9	13.7	19.3	21.9	23.7
SBI20 index	1.448	1.183	1.405	1.706	1.806	1.808
No. of securities	49	82	129	173	237	266
(Shares)	27	52	85	122	180	197
(Bonds)	22	30	44	51	56	68
Volume (in bn SIT)	88	87	108	173	266	270
Volume as % of GDP	4.0	3.4	3.7	5.3	7.3	6.6
Liquidity (V/MC) of shares	1.12	0.54	0.28	0.28	0.30	0.21
Liquidity (V/MC) of bonds	0.33	0.25	0.14	0.15	0.16	0.22

Source: Securities market agency, 2000.

Primary market: In 2000 five bond issues (mostly by banks) and one share were publicly offered, in the amount of 11 bn SIT. In the period 1994-2000 there were altogether 22 shares (13 by banks) and 44 bonds (34 by banks) publicly offered. The most important issuer is still the government. In 2000 it publicly offered 12 bonds and 23 treasury bills in the total amount of 102 bn SIT (long-term securities accounting for 37 bn SIT).

Takeovers: Takeover act provides that a takeover bid must be made if a person acquires at least 25% of voting rights of a joint-stock company. The rising trend in the number of successful company takeovers took place also in 2000, with considerable impact on organised security market and off market trading. Nominal value of takeovers in 2000 was 11 bn SIT, while the market value was 31 bn SIT (which is a considerable increase since last year (14 bn) and a year before that (0).

Secondary market: Market capitalisation off all securities on the organised market amounted to 967 bn SIT in 2000, which is 22% increase from a year ago. The growth of market capitalisation was primarily the result of new securities being listed on the Ljubljana stock exchange (LJSE). Market capitalisation of shares was 705 bn and of bonds 255 bn SIT (the

difference to total market capitalisation is due to pension coupons). If we include privatisation funds as specific group, market capitalisation of their shares was 172 bn in 2000, which gives a broader figure for total market capitalisation of 1.139 bn SIT in 2000. Market capitalisation as a % of GDP was 24% (or 28% with privatisation funds shares included).

Volume of trading: Turnover on the organised market was a record one, although it increased only by 1.5% in nominal terms from the last year. In the total volume of 270 bn, share volume was 145 bn, trading in privatisation funds was 63 bn and bond volume was 56 bn SIT. Trading in shares still dominate, although trading in bonds (21% growth) and in privatisation funds shares (23% growth) were becoming increasingly important.

Number of securities: In 2000 the number of securities traded in the organised market increased to 266: On the stock exchange market there were 94 securities, 40 shares and 54 bonds. On the free market part there were 157 shares (of which 43 shares of privatisation funds), 14 bonds, 1 pension coupon and 8 short-term securities.

Concentration: 10 most trades shares contributed to 54% of the total volume of share trading. 10 most traded bonds accounted for 51% of the total volume of bond trading.

Grey market: Trading in securities also takes place off the organised market. The volume of such transactions was 171 bn SIT in 2000, 27% more than a year ago, which means 64% compared to trading on the organised market. 75% of the trade off the organised market was trading in privatisation shares – shares of companies that have come through the ownership transformation process.

Participants: In 2000 there were 34 authorised (licensed) participants to carry out securities transactions, 11 banks and 23 brokers firms.

Deals: In 2000 there were on average 1.585 deals per trading day with an average daily value of 1.08 bn SIT.

Block trading: It was introduced to LJSE in 1997, initially for trades above 15 mio, and since 1998 for trades above 30 mio SIT. Total value of block trading in 2000 was 156 bn, which is

58% of the annual volume traded on the organised market. Block trading increased in value by 19% from a year ago.

Market indices: Mot important indices are SBI 20, Slovenian market index of 20 ordinary shares, weighted by their market capitalisation (with starting value of 1000 in 1993), PIX index of privatisation funds and BIO bond index.

Non-residents: In 2000 non-residents net purchased securities in the amount of 0.2 bn SIT (compared to net outflow 2.2 bn SIT a year ago), while the volume of trading was 4.3 bn SIT (or 35% more than a year ago). This shift is mostly due to the relaxation of Bank of Slovenia's regulation towards foreign portfolio investment in this year.

Investors and their placements in securities: Investments in securities via brokerage firms and banks are grouped in three segments: a) placements for the house account of brokerage firms (and banks), b) securities management for investors, and c) brokerage (placement for investors with brokers as agents). Total value of investments via brokerage firms (and banks) was 824 bn SIT in 2000 (an increase of 26% from the last year). Of this amount, 28% belongs to the first group, 2% to the second (servicing slightly above 1000 clients) and 70% to the third group (servicing over 100.000 clients).

Investments in foreign securities market: The foreign exchange operation law of 1999 and subsequent executive regulations allow unrestricted investment in foreign securities by banks and insurance companies if they operate for their own account, and by other residents only in certain first class securities (or in other securities under conditions set by Bank of Slovenia). In this case, trading must go through a broker. The value of such trade was 80 bn, ob which own investment was more than half and brokerage somewhat less than half. Large majority of the trade was in bonds (75 bn), mostly in eurobonds of the Republic of Slovenia (in last five years Slovenian government issued five eurobonds on the foreign capital markets).

Institutional investors: Investment funds (privatisation funds and mutual funds) deserve special attention. Other players include banks, insurance houses, pension funds. State pension fund and restitution fund are both specific institutions, originating in the process of ownership transformation and most similar in their characteristic to privatisation funds, although being in the state ownership.

Privatisation funds: End 2000 there were 43 PF shares listed on the organised market. Total book value of their assets was 573 bn SIT. In this, unused privatisation vouchers accounted for 32% (51% a year ago). Their investments are mostly in shares (57%), both on organised market (22%) and off the market (35%). Market capitalisation of PF shares accounted for 15% of the total market capitalisation (with PF shares included). PF were managed by 19 management companies.

Mutual funds: Mutual funds are underdeveloped. They are too small to have an impact on the capital market. At the moment, their foreign assets are limited to 10% of their investment portfolio. There were 19 mutual funds operating in 2000, managed by 11 management companies. Total net value of their assets was 10 bn SIT, 22% more than a year ago. The market share of the largest one is 47%, while the largest management company (managing three mutual funds) has a 64 share in the total assets of mutual funds. Shares account for 79% and bonds for 12% in their investments. Although the number of investors increased by 36% from last year, it is still very small (around 12.000 people).

Pension funds: Pension reform in Slovenia started late, in early 2000, when legislation was adopted. Therefore, pension funds are at an early stage of their development. An investment pillar for retirement insurance introduced by the pension reform will have an important impact on the capital market in the years to come, primarily because of the additional demand it will create. In 2000 preparations began for the introduction and offering of this new product in the market.

4 Capital market in Hungary

Hungarian capital market started to develop in the early nineties and later exhibited an impressive growth in a relatively short period. Infrastructure and extensive regulatory framework were established first, and new listings gradually entered the market. Equity market was rather passive and underdeveloped until 1995, when foreigners discovered the Hungarian capital market, first investing in government securities, but later also in corporate shares, so that market capitalisation, trading volume, prices and liquidity of the securities market increased fast. Equity market reached its record levels in 1997-97 period, while in 2000 there was a decline in the market indicators. However, trading in government fixed-

income securities still dominates the securities market. Hungarian capital market is today definitely one of the most developed in the region (among Central European economies, not to mention among other transition countries), and is in certain aspects quite comparable to some Western capital markets.

Securities market consists of Budapest stock exchange (BSE) and OTC market. BSE has 42 members, of which 36 brokerage firms and 6 banks. Of 42 members, 40 are active on the equity part of the market, 24 on the government securities segment, 29 on futures market part and 27 on options market section. For BSE the most important prices index is BUX. In March in reached its record value of 10.471,91 points (after its general rising trend in 1995-2000 period), exceeding its 1999 closing by l8.7%. BSE also publishes CESI index, a widely used Central European stock market indicator.

Development of the Hungarian capital market was influenced by the fact that Hungary was one of the first transition countries to start implementing reform of the social security system. Pension reform started early on which contributed to the early emergence and growth of domestic institutional investors on the market (pension funds, close-end and open-end mutual funds). Contrary to Slovenia, where pension funds are still practically nonexistent and close end mutual funds surged as the side-product of privatisation process, mutual funds in Hungary developed independently of the privatisation process.

Another difference between the Hungarian and Slovenian capital market is in the role of foreign investors. While Slovenian capital market was, due to privatisation concept and restrictive regulation later, when many barriers kept foreign investors at the distance, relatively closed to foreign investors, in Hungary liberalised regulation attracted foreign investors to both direct and portfolio investment on the capital market, which boosted trading volume and liquidity in the market. As a consequence of the presence of foreign investors, particularly large institutional investors (mostly foreign banks), Hungarian securities market is more developed and particularly much more liquid than the Slovenian one (which is considered by foreigners as one of the least liquid in the region). This is shown in all indicators (see Table 3), except in the number of listed securities, which is larger in Slovenia, due to the issuance of many privatisation-related shares. In Hungary however, equity market remains a less developed segment of the capital market (compared to its fixed-income securities part), while

in Slovenia, again due to privatisation-related shares, equity part of the capital market now dominates.

In the following, some data on the development of the Hungarian capital market are presented (Table 2) and a comparison among some indicators of capital market development between Slovenia and Hungary is given (Table 3).

Table 2: Some basic data on development of capital market in Hungary

	Market capitalisation				Volume (Turnover) – single counted, end 2000	
	Mio USD		% of GDP			
	end 1997	end 2000	end 1997	end 2000	Mio USD	% of GDP
Equity market	15.195	11.936	33.2	25.9	12.106	26.2
Debt securities market	13.199	15.707	28.9	34.0	70.840	153.6
- central government	13.017	15.510	28.5	33.6	70.669	153.2
(T – bills)	3.249	2.941	7.1	6.4	19.120	41.4
(T – bonds)	4.908	7.811	10.7	16.9	51.550	111.8
- other issuers (banks, companies, municipalities)	182	197	0.4	0.4	170	0.4
Total	41.394	37.643	62.1	59.9	82.946	179.8

Table 3: Comparison of some indicators of capital market development in Slovenia and Hungary (equity market, end 1999, Mio USD)

	Market capitalisation	MC % of GDP	No of equities	Volume (turnover)	V/MC (liquidity)
Slovenia (LJSE)	2.854	14.3	135	1.203	0.42
Hungary (BSE)	16.317	33.7	66	14.847	0.91

5 Capital inflows

Capital inflows in Slovenia have been relatively low by international standards and particularly when compared to other Central European (CE) transition countries. Even in the period 1994-97, when they were at the highest level of 3.7% of the GDP annually on the average, compared to other CE countries this was not much. For the period 1993-2000 capital inflows in Slovenia were at the level of 2.3% of GDP annually, while in Hungary they were much higher, at the level of almost 9% of the GDP (this figure includes public and private capital

inflows and is calculated as a change in official international monetary reserves minus current surplus in the balance of payments, expressed as a % of GDP). In Slovenia, public capital inflows were not significant, so private capital inflows are close to total capital inflows.

In Slovenia, capital inflows exhibited an increasing trend until 1996, when they reached a peak, later declined and again reached high levels in 2000 and 2001. They are expected to increase further in the next couple of years. Capital inflows in Slovenia did not have any destabilising macroeconomic consequences. In fact, they undoubtedly had some positive effects on the economy (such as closing the investment/saving gap and thereby helping Slovenian catching up with the EU), but they did put some pressure on the Bank of Slovenia (BS, Slovenian central bank) in the conduct of its monetary and exchange rate policy.

Capital inflows to Slovenia were mostly driven by domestic residents in the form of their borrowing from abroad, mainly driven by relatively high interest rate differential. Borrowing from abroad contributed to around 70% of total capital inflows, while FDI and foreign portfolio investment were less important, contributing to some 30% of total capital inflows. FDI have been modest throughout the period, at the level of less than 1% of GDP, mostly as a result of exclusion of foreigners from mass privatisation process and of delay in privatisation of large public enterprises and banks. Some analysts claim that although FDI themselves were not restricted, restrictions on foreign portfolio investment may have indirectly discouraged FDI as well. Foreign portfolio investment driven capital inflows started to increase in the 1995-97 period, but later they practically disappeared after BS introduced restrictions on foreign portfolio investment in 1997. These capital inflows reappeared only in 2000 and 2001, after the relaxation of the restrictions in 1999 (and their elimination later in mid 2001). In short, capital inflows being mostly residents-driven and of the foreign borrowing and FDI type, they were not of speculative nature nor easily reversible.

On the other hand, in Hungary FDI were very important throughout the transition period. In recent years FDI are at the level of around 3% of GDP, but in the 1991-97 period they were higher, 5% of GDP and in some years considerably higher. Foreign portfolio investment (particularly investment of foreign institutional investors in government fixed-income securities) were around 2-3% of GDP in the second part of the nineties. It is estimated that Hungary in fact absorbed almost half of all foreign capital invested in CE economies.

In Slovenia, policy reaction to capital inflows was first sterilisation and later, after 1995, resort to capital controls. It should be mentioned that BS is formally a monetary targeter, but within the framework of managed floating exchange rate regime, used throughout the transition period, in practice exchange rate was strongly targeted as well. In fact, with a substantial intervention (plus sterilisation) on the foreign exchange market, BS was trying to prevent real exchange rate appreciation of the domestic currency which would otherwise result as a consequence of capital inflows.

Capital controls were introduced in 1995, first in the form of unremunerated deposit requirement on residents' short term borrowing abroad (with short term defined as five and later adjusted to seven years), and later, in 1997, in the form of costly custody accounts on foreign short term portfolio investment. In 1999, as the result of the Association agreement with the EU entering into force, capital controls had to be lifted, except for foreign portfolio investment restrictions, which could have been retained by 2003 at the latest.

6 Institutional framework

It is widely recognised that for transition countries on their way to normally functioning market economies, comparable to EU countries, institutional change is one of the crucial challenges. These countries until nineties developed in the very specific institutional context and still have to build up some market institutions which are in the Western economies taken for granted. Of course, automatic or mechanic transplantation of Western-type institutions may sometimes be impossible or even counterproductive, so that some transition-related particularities should nevertheless be taken into account when shaping institutional framework in transition economies.

In Slovenia, specific context in which development of institutions is framed is determined by two processes. First is related to the recent past - disintegration from former Yugoslavia, and second is related to the near future - integration in the EU. As far as the shaping of institutions is concerned, the first process, obtaining independence and becoming a national economy instead of a regional economy (as a republic in former Yugoslav federation) meant creating an almost completely new institutional set up, by creating numerous new institutions and radically transforming the existing ones.

On the other hand, the shaping of institutional framework is now foremost determined by the process of Slovenian integration in the EU. In the process of EU accession negotiations, Slovenia closed 26 of 31 chapters, including the chapter on capital movements, and is now leading in front of other candidate countries in this respect. Slovenian legislation on financial system is largely adjusted to the EU requirements. An impressive number of laws and executive regulations has been passed in recent years to comply with the requirements of the acquis communautaire. EU directives are largely incorporated in basic legislation, but a lot still has to be done in a relatively short period of only a couple of years before the EU accession - not only in adopting EU legislation, but also in implementing it into real life. EU directives related to financial system were largely incorporated in the 1999 package of EU-harmonising legislation (Banking law, Foreign exchange operations law, Securities market act, etc.).

In the area of capital markets, Slovenia has almost completely liberalised capital flows by now and committed itself to abolish all residual restrictions by end 2003, before its expected EU accession. Bank of Slovenia (Slovenian central bank) was rather reluctant to lift itself short term capital controls, particularly restrictions on short term foreign portfolio investment, but finally had to commit itself to a timetable of gradually phasing them out. Later, when circumstances changed, Bank of Slovenia rushed ahead of its schedule and completely liberalised foreign portfolio investment in mid 2001. There are only some minor restrictions related to domestic physical persons and to some short term money market instruments left, which Slovenia has to eliminate by end 2003 at the latest. However, Bank of Slovenia reserved the right to reintroduce some capital control measures for the period of up to six months in case of exceptional and severe balance of payments disturbances.

Also, in the process of negotiations on the capital movements chapter of acquis communautaire, Slovenia expressed a concern that having to liberalise capital flows completely, Slovenia (as a very small monetary area) may become particularly exposed and vulnerable to external shocks (coming from shifts in unpredictable and possibly speculative short term capital flows), while, on the other hand, without having any measures of protection or assistance, such as those which are available to the EU and/or eurozone members. However, the EU Commission did not show much understanding for the Slovenian arguments.

In relation to capital movements, public debate in Slovenia concentrated on another issue. Slovenia was, against its will, practically forced to open its real estate market very early, much before the EU accession and in fact earlier than other candidate countries, for the simple reason that one of the neighbouring countries imposed this as a condition for its signing of the Slovenian association agreement with the EU. A kind of compromise solution was finally found, but it raised a lot of public dissatisfaction and criticism, mostly for the fear that Slovenia would not be able to protect its prime property (say along the very short Slovenian coast) in domestic ownership once confronted with the "EU-wide" market demand coming from much larger and richer neighbouring countries.

Returning to capital market, what matters for its institutional framework is adequate legal and supervisory environment, with many elements which determine its quality, such as investors' rights (shareholders' rights, creditors' rights) and quality of law enforcement (rule of law, attitude towards foreign investment, corruption etc.). Institutional framework in which capital markets operate involves prudential regulation and supervision of actors and activities in the market. In Slovenia, supervision of financial sector is organised separately in three distinct supervisory authorities. Bank of Slovenia supervises the banking sector, Securities market agency supervises the capital market and Insurance supervisory agency supervises insurance companies. Contrary to this, in Hungary a new institution, Hungarian financial supervisory authority, was established with the integration of former separate financial supervisors, thus opening the door for the comprehensive supervision of the entire financial system.

Finally, in the context of capital market development the term institutional framework would perhaps imply some discussion on the role of institutional investors as very important and specific players on the capital market. This issue, however, was dealt with earlier in the text, in the framework of the analysis of capital market development in both countries.

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CAPITAL MARKET DEREGULATION, FINANCIAL INTEGRATION AND MACROECONOMIC PERFORMANCE IN THE NORDIC COUNTRIES IN THE 1980S AND 1990S: ARE THERE ANY LESSONS?

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1. Introduction

This paper reviews the Nordic experiences of capital market liberalisation and exchange rate regime experiments in the 1980s and 1990s, and their macroeconomic consequences. The large cyclical swings and many macroeconomic imbalances experienced in these countries makes one prone to suggest that financial integration is not necessarily a straightforward or an easy process. The Nordic economic problems were closely – although indirectly – related to international and especially European integration. They may hence provide some lessons for the eastern enlargement of the EU. When new countries entry the union, it has to be decided what kind of currency regime they should adopt; to join the Eurozone immediately, to have a ERM-type quasi-fixed regime or to float. In the light of the Nordic experiences it is not self-evident that financial and macroeconomic adjustment processes linked with these alternatives will be problem-free.

2. The gradual integration process of the Nordic countries

Although the Nordic countries are very similar, they have chosen different ways of economic integration and political alignments. The differences originate from the aftermath of World War II, when Norway, Denmark and Iceland joined NATO and Sweden and Finland remained neutral. In the beginning of the 1950s Nordic Council was established to promote Nordic co-operation. It brought a Nordic passport union and free mobility of labour already in the 1950s but it did not lead to deeper economic integration. In order to promote free trade Denmark, Norway and Sweden established EFTA in 1959 with the UK and few other European countries. Finland joined EFTA as an associate member in 1961 and as a full member in 1986, and Iceland became a member in 1970. In the end of the 1960s there was an attempt to establish a Nordic economic union called Nordek, but that attempt failed when Denmark decided to join EEC in 1972 together with the UK. At the same time Norway's membership in EEC was rejected first time in a referendum.

This well-established set up based on Danish EEC membership and the EFTA-memberships of the other Nordics was fundamentally changed in the beginning of the 1990s as a result of the accomplishment of internal market program and Maastricht Treaty of the European Union. The EFTA countries started to negotiate new trade arrangements with the EU in order to maintain free access to the internal market. The result of this process was the creation of the European Economic Area (EEA) in 1994 with integrated goods and capital markets. However, at that time Finland, Norway and Sweden were already negotiating over full membership with EU, which they had applied for in 1991. After referendums in autumn 1994 Finland and Sweden decided to join EU in the beginning of 1995. Norway's membership was once again rejected in a referendum. As a result, Norway and Iceland stayed outside of the EU and relied on the EEA agreement in their integration policy.

The deepening of European economic and political integration has continued within the EU. The development towards monetary union was agreed upon in 1991 in the Maastricht Treaty. When Finland and Sweden started negotiations over EU membership, they were obliged to accept the Maastricht Treaty, and EMU as an unavoidable part of the union membership in future. Denmark, instead, as an old member did not accept the Treaty[1] and it finally got a formal right to opt-out of the monetary union. Although Sweden does not have such a

[1] It was first rejected in a referendum.

formal right to opt-out of EMU Sweden has decided to stay out, at least for a while. As a result, Finland is the only Nordic country which belongs to EMU. Finland joined the monetary union without any hesitation.[2]

3. Capital market liberalisation

The impact of the gradual process towards deeper integration started already in the 1980s – before the EEA agreement and the Swedish and Finnish EU memberships – when the Nordic countries joined the European process of deregulation and liberalisation of financial and goods markets. As a central part of integration process all Nordic countries liberalised their domestic financial markets which earlier had been subject to extensive regulation. This happened in the mid-1980s, first in Denmark and Norway, and a few years later in Sweden and Finland.

In the golden years from the 1950s to early 1980s the economic policy put much emphasis on full employment in all Nordic countries. Full employment was achieved by employing Keynesian ideas of economic policy: active demand management, continuous public sector growth and incomes policy through centralised wage bargaining. The Bretton Woods system enabled this policy model. Due to regulation of domestic credit markets and international capital movements the governments were able to control interest rates and investment activity. Eventually the policy of rapid growth and full employment caused inflationary pressures. This, of course, was not rare amongst the Western countries in the 1950s and 1960s. However, the Nordic countries (except Denmark which adopted the common EEC macroeconomic guidelines earlier than other Nordics) continued this policy longer than most other European countries which adopted tight anti-inflationary policies in the beginning of the 1980s notwithstanding the rising unemployment.

Perhaps the biggest changes caused by integration were the deregulation of capital movements in the 1980s and changes in exchange rate policy. These changes took place in all Nordic countries well before the EU membership became actual. However, they were necessary steps of integration and preconditions of EU membership. Liberalisation of

[2] In fact, EMU membership and the fulfilment of the Maastricht criteria was the objective of Finnish economic policy even before the Finland officially joined the EU.

international capital movements, deregulation of banking and pursuit of fixed exchange rate and disinflation were parts of economic policy which aimed to integration.

The deregulation of domestic banking sector and partial liberalisation of international capital movements in the 1980s increased the supply of credit. Within a period of two or three years, all Nordic countries gave up their earlier systems of interest rate controls and restrictions of foreign borrowing. The banks suddenly had seemingly unlimited resources which they started to offer to borrowers. The households and firms, which earlier had been subject to various restrictions, were now able to raise credit as much as they wished. As a result, private sector indebtedness, domestic demand and asset prices increased very quickly. These changes led to widening current account deficits. Similar things happened also in the UK in the 1980s and in many Asian countries in the 1990s. The booms were caused by financial deregulation, which was part of an international wave of deregulation of capital markets and economic and financial integration. In the first phase there was an abundant supply of credit and lower interest rates. As a result, asset prices rose, output and employment increased and inflationary pressures were build up.

The fact that all Nordic countries experienced a turbulent economic cycle of boom and bust between 1987 and 1994 at the same time with advancement of economic integration makes is difficult to separate the impacts of integration from those of the economic crises and the subsequent stabilisation policies. However, in what follows we are going to argue that the same policies and regime shifts which formed a central part of national integration policies – especially financial deregulation and policy of fixed exchange rates – were also integral factors explaining the Nordic recessions and financial crises.

4. The Nordic financial crises

The measures which aimed to financial deregulation together with expansive macroeconomic policies enabled or started a large-scale adjustment and restructuring processes in all Nordic countries, and finally promoted economic crises. In many cases such developments were followed by a recession. There was a banking crisis in the aftermath of debt-financed booms in Norway in the latter half of the 1980s, and in Sweden and Finland in the early 1990s. All Nordic countries experienced also a currency crisis in 1992 together with many EMS

countries. The Nordic and the UK recessions and debt-crises of the end of 1980s and early 1990s were preceded by debt-financed investment and consumption boom in the late 1980s.

It can be argued that the crises experienced in the Nordic countries in the early 1990s were connected with the integration policy – financial deregulation, policy of fixed exchange rates, fiscal consolidation. It has to be acknowledged that the impacts of integration are not easy to separate form those of the other sources of economic crises and the subsequent stabilisation policies. At the same time when capital markets were liberalised the Nordic countries tried also to adopt European exchange rate policies by linking their currencies to the EMS currencies. These attempts finally failed when all Nordic countries experienced severe recessions. As a result of the recessions, all Nordic countries went through a period of disinflation, and adopted macroeconomic policies aimed to low inflation and sound fiscal balance.

Finland and Sweden suffered in the early 1990s from recessions which were among the worst experienced in these countries during the 20th century. Output fell by 10 and 5 percent in each country, respectively, and unemployment rose to a far higher level in the mid 1990s than in the depths of the great depression of the 1930s. While the experience of Finland and Sweden in the early 1990s – declining output in three consecutive years – was unique in the OECD, other Nordic countries and the United Kingdom had similar though milder recession and unemployment patterns. In fact, there was a recession at the same time in almost all European countries.

What were the crucial factors that caused the recessions in the Nordic countries? First, it seems obvious that the Nordic recessions were connected with the failure of the European system of fixed exchange rates (especially with the European Monetary System, EMS) and high interest rates imposed before that to all European countries through the EMS by the German central bank, the Bundesbank. The climax of the recession was the European currency crisis in the autumn of 1992. There was a recession in the USA, too, but it turned to be much milder and shorter.

If measured by cumulative output and employment losses, the recessions of the Nordic countries were much deeper than those in other European countries or in the USA. There were common factors which help to explain the bad Nordic record. All of them had fixed

exchange rate and overvalued currency before the crisis. Also their inflation rates were higher than those of the core countries of the European currency system. In addition to this, there were credit expansions, current account deficits, and asset bubbles in the end of the 1980s which made the imbalances even worse.

The Nordic recessions were preceded by debt-financed investment and consumption boom in the 1980s. The booms were not only enabled but most likely also caused by fatal interaction of financial deregulation and fixed exchange rate regimes, which in turn were at that time essential parts of gradual integration process. In the first phase there was an abundant supply of credit and lower interest rates. As a result, asset prices rose, output and employment increased and inflationary pressures were build up.

TABLE 1. The economic crises of the late 1980s and early 1990s

	Years of recession	Relative employment change, percent	Largest output gap (OECD estimate), percent of GDP	Change of inflation, percentage points	Increase of unemploy-ment, percentage points
Finland	1990-93	-18.8	-11.3	-6.0	14.9
Sweden	1991-93	-14.7	-5.3	-9.5	6.5
Norway	1988-90	-8.7	-4.3	-7.3	3.9
Denmark	1987-93	-6.5	-5.5	-3.5	4.5
EU	1992-93	-4.0	-2.9	-3.1	3.7
USA	1990-91	-1.0	-2.5	-2.8	2.2

Source: OECD Economic Outlook (2000)

The boom of the late 1980s turned into a bust consecutively in Norway, Finland and Sweden – a period of high interest rates, falling output and collapsing asset prices, debt-deflation, financial and banking crises and currency crises of varying degrees in all these countries. Especially in Sweden and Finland this destructive process began when investors started to

lose their confidence as a result of worsening current account deficits and deteriorating profitability of firms. These were caused by increasing competitiveness problems, decreasing demand in the export markets due to international business cycle (and in the Finnish case also by the decline of Soviet trade), and by rising European interest rates. All these factors together started to erode the credibility of the policy of fixed exchange rates which was pursued by the Nordic governments and central banks.

There are factors which help to explain the exceptional severity of the Finnish and Swedish crises, and which are common to many countries which have experienced similar crises. First, Finland and Sweden, like many other countries, had a fixed exchange rate regime and an overvalued currency before the crisis resulting from inflation rate which was higher than in the core countries of the European currency system. Secondly, the inflation and currency overvaluation problems were originally caused by a credit expansion and capital market deregulation in the latter half of the 1980s.

In years 1989-92, there was an almost continuous market pressure against the fixed exchange rate parity, and the central banks of Sweden and Finland tried to defend the exchange rate by raising interest rates, a policy which soon started to harm firms and households. The interest rates fluctuated on very high level while inflation rate decreased, thus rising the real interest rate enormously.

Households and firms responded in these countries to high and volatile interest rates by increasing savings and cutting investment, a change that quickly led to downward spiral of domestic demand and asset prices. High interest rates in a debt-ridden economy constrained private demand effectively. Overindebted firms and households were forced to sell their assets, and falling asset prices caused negative equity and balance-sheet problems. As a result output fell for three years and unemployment soared. A similar chain of events was experienced in Norway a few years earlier, although the macroeconomic consequences of the Norwegian banking crisis were milder.[3]

The stubborn continuation of tight monetary and exchange rate policy made the recessions deeper. Afterwards it seems obvious that the recessions of Finland and Sweden were

[3] The perils of fixed exchange rate regimes lacking sufficient credibility is analysed in Svensson (1994). Debt-deflation is discussed e.g. by King (1994) and Wolfson (1996). The Nordic banking crises are described and analysed in Englund (1999), Steigum (1992) and Vihriälä (1997).

connected with the failure of the European system of fixed exchange rates (especially with the European Monetary System, EMS) and high interest rates imposed before that to all European countries through the EMS by the German central bank, the Bundesbank. The climax of the recession was the European currency crisis in the autumn of 1992. It is likely that both the boom and bust phases could have been stabilised by adopting a floating exchange rate. However, all European countries tried to maintain exchange rate fixed, which made the recessions of the early 1990s worse.

In a way it was unavoidable that highly leveraged economies like the Nordic ones in the 1980s were bound to suffer from an interest rate shock. In this respect the Nordic banking crises had much common with the crises of Asia and Latin America of the second half of the 1990s. In the 1990s it became almost a rule that countries with financial deregulation and subsequent build-up of foreign-currency debt were almost bound to face either a currency or a banking crisis or both, if they had a fixed exchange rate.

What was the role of exogenous factors? There is a widespread view of Finnish crisis as a result of the Soviet collapse but closer analysis shows that is an oversimplified and inaccurate explanation. It is true that Finnish exports to Soviet Union decreased suddenly in 1991. Sweden had also problems with exports at the same time and Norway suffered from low oil prices when she was hit by the financial crisis. However, exports recovered in all Nordic countries rather quickly. The recession of domestic demand turned out to be much more long-lasting and deeper than any cyclical export problems.

Another exogenous shock might have been the international recession. However, that began in European countries in 1992, clearly later than the Nordic recessions. The European recession of 1992-94 did not either cause elsewhere such severe consequences as in Finland and Sweden. It is hence difficult to argue convincingly that the Nordic financial crises would have been caused mainly by outside factors. On the contrary, it seems likely domestic policy failures had an important role. The recessions were clearly financial and monetary by nature. The recessions started with high interest rates which eventually led to debt deflation and contraction of domestic demand. The deflationary processes ended in Sweden and Finland only when the countries with many others allowed their currencies to float and depreciate in the autumn of 1992. After that interest rates decreased and domestic demand and employment gradually revived.

It is clear that the strong export growth of Sweden and Finland in the years 1993-2000 was primarily enabled by the dramatic improvement in competitiveness which originally was achieved through abandonment of fixed exchange rate regime and subsequent currency depreciation. What was surprising was how durable this improvement was. The competitiveness was not eroded by wage inflation in the 1990s – contrary to what has happened many times before, in the 1960s, 1970s and 1980s. It is usual to argue in textbook macroeconomics that nominal changes like exchange rate movements have only temporary effects and in longer run they are assumed to be neutral. The Swedish and Finnish experiences contradict this conventional wisdom.

TABLE 2. Fiscal balance in the crisis

	Surplus in boom 1987-90 (1)	Surplus in bust 1993-95 (2)	Surplus in year 2000, after the recovery (3)	Change from boom to bust (2)-(1)	Change from bust to 2000 (3)-(2)
Finland	6.3	-7.9	6.9	-14.2	+14.8
Sweden	5.4	-12.3	4.1	-17.7	+16.4
Norway	5.1	-1.4	14.8	-6.5	+16.2
Denmark	3.4	-3.9	2.8	-7.3	+6.7
Nordic 4	5.1	-6.4	6.0	-11.5	+13.5
EU	-2.5	-6.5	0.6	-4.0	+7.1
USA	-4.1	-4.7	1.7	-0.6	+6.4

Source: Author's own calculations based on data of OECD Economic Outlook (2001).

The recessions were successful in reducing the high Nordic inflation rates which in the 1980s were higher than those of the core EMS countries. After the recessions the Nordic inflation rates were close to those of other European countries. Disinflation is seldom cost-free and it

clearly was not in this case. It was the rise of unemployment which in part helped to get price and wage pressured down.

The Nordic recessions caused also a lot of strain to the public finances.[4] Initially the Nordic public sectors were in healthy surplus. The recessions, unemployment and high interest rates changed the situation quickly and fiscal balances deteriorated significantly; on average the change was more than 10 percent of GDP. Although the change was big and sudden, it was proportional to the employment losses as can be seen from Table 2. Hence there is no reason to argue that the large deficits would have been caused by expansionary fiscal policy.

5. Recovery of the Nordic economies and changing capital markets

After the deep recessions of the early 1990s, all Nordic countries have experienced a strong recovery. On average, the post-recession Nordic growth rates of output, employment and productivity are almost the same as in the USA in the same period, and much better than the EU average. Within the Nordic group, the output growth has been fastest in Finland and Iceland, and employment growth has been about two percent per annum in Finland, Iceland and Norway. Highest productivity growth has been achieved in Finland and Denmark.

Sweden and Finland are different from the other Nordic economies. The both counties went in the 1990s through a big shock and a big change. An exceptionally deep recession was not followed by a new boom in domestic demand as in the other Nordic counties (and in the USA) but a rapid structural change and export-led growth. At the same time Finnish and Swedish economies were opened up to foreign imports even in previously protected sectors and to foreign ownership. The export-led industrial growth was in both countries enabled by huge improvements in competitiveness. The real exchange rate depreciation was achieved first by nominal depreciation of the currencies during the European currency crisis in the 1992 and then maintained by wage moderation and rapid productivity growth in manufacturing. This development was actually similar to that of Euroarea.

[4] There have also been studies suggesting that the so called non-Keynesian effects of fiscal policy might have contributed to the recessions of Sweden and Finland, or that the crises would have partly been caused by excessive deficits (see Corsetti and Roubini [1996] and Giavazzi and Pagano [1995]). However, by looking to the timing of the output losses and rising deficits it is very hard to accept such a conclusion – unless one believes that consumers were able to predict the recession well in advance.

In Finland and Sweden there are also microeconomic reasons for improved economic performance; the depression of the early 1990s was a period of Schumpeterian creative destruction, which was followed by structural change, emergence of new trading partners and new industries. The structure of production has shifted in both countries from traditional engineering and forest industries to growing share of high tech products and ITC, as exemplified by the rise of mobile phone industry giants Ericsson and Nokia. Such a deep structural change did not happen in Denmark and Norway, which had much milder recessions.

It is possibly to view the Finnish and Swedish adjustment processes as consequences of integration, as a change towards more openness and to more exports, more imports, mergers and international ownership[5], relocation, and finally job creation. Firm structure integrated rapidly according to logic of the single market, and new governance culture emerged through foreign ownership. There is a long list of large Swedish firms which merged with or were acquired by big foreign companies in the 1990s; ABB in engineering, acquisitions of Saab and Volvo by General Motors and Ford, respectively, in automotive industry, mergers of Avesta-Sheffield in steel, Pharmacia-Upjohn in drug and Stora-Enso in paper industry, Nordea Bank in banking and Sonera-Telia in telecoms.

The period of economic recovery after the crises of early 1990s has witnessed a wave of mergers and acquisitions, especially in Sweden and Finland. They have been reactions to European economic integration and structural change on one hand, and they have been enabled by full liberalisation of the Nordic capital markets and foreign ownership on the other. There emerged also structural changes in corporate governance and ownership structure. The importance of stock market and equity finance increased during the 1990s and the older financial system based on cross-holdings and dominants role of banks faded. These changes were speed up by rising stock market valuations during the latter half of the 1990s. Shareholder value and equity finance got important support also from reforms of capital income and corporate taxation in the Nordic countries during the 1990s. Earlier high rates for corporate and dividend income taxes were abolished and substituted by relatively low and flat taxes.

[5] There is a long list of large Swedish firms which merged with or were acquired by big foreign companies in the 1990s; ABB in engineering, acquisitions of Saab and Volvo by General Motors and Ford, respectively, in automotive industry, mergers of Avesta-Sheffield in steel, Pharmacia-Upjohn in drug and Stora-Enso in paper industry and Merita-Nordbanken (known as Nordea today) in banking.

There were also large swings in current accounts of Finland, Sweden and Norway during the 1990s. in Denmark similar change took place already in the 1980s. The countries which used to run current account deficits in the 1970s and the 1980s ended up to maintaining large current account surpluses in the end of the 1990s. Partly this change reflected the strong exports and (in Sweden and Finland) relatively depressed domestic demand (see Table 3).

TABLE 3. Characteristics of the recovery; annual average growth rates from the end of recession to 2000

	GDP	Exports	Change of current balance from 1992 to 1999, percent of GDP
Finland	4.7	10.6	+12.1
Denmark	3.5	6.7	+0.1
Norway	3.4	5.7	+10.8
Sweden	3.1	10.6	+5.9
Nordic 4	3.7	8.4	+7.3
EU	2.5	7.7	+0.6
USA	3.8	7.9	-3.7

Source: OECD Economic Outlook

Previously the Nordic current account deficits were financed mostly by public and private sector borrowing. Current account surpluses have meant that these cumulated foreign debts of the countries have been reduced significantly in recent years and in the case of Norway even turned into large foreign assets. The Nordic countries have not been very successful in attracting foreign investment. On the contrary, a large share of the investments made by the biggest Nordic firms are foreign ones.

Instead of foreign direct investment Finland and Sweden received significant amounts of portfolio investments from the international capital markets. As a result, a large share of Finnish and Swedish listed companies are now owned by foreign institutional investors.

6. Challenges facing different monetary regimes with integrated capital markets

A central part of the Nordic integration processes in the 1980s and 1990s have been changing monetary regimes. First in the 1980s all the Nordic countries had fixed exchange rate targets; they tried to imitate the exchange rate mechanism of the EMS although they were formally outside of it. After the currency crises of 1992 the paths of Nordic countries started to diverge. Finland's goal was to join the EMU. Denmark decided for political and clearly non-economical reasons to stay formally outside the monetary union but still have a fixed exchange rate vis-a-vis the euro. The rest of the Nordics – Sweden, Norway, Iceland – have remained in the regime of floating exchange rates with explicit inflation targets. In spite of different choices, all Nordic countries have adopted the policy of low inflation and central bank independency. The adjustment process to this new regime of stable prices was initially painful for all of them although the new regime has proven well-functioning afterwards.

As a consequence of different paths in integration policies, the monetary regimes of the Nordic countries are now different. Finland belongs to EMU and has a voice in the determination of the ECB's monetary policy. Denmark does not belong to EMU but still the Danish central bank tries to keep the exchange rate fixed in relation to euro and hence does not have independent monetary policy in practise. Sweden, Norway and Iceland have all floating exchange rates and independent monetary policy. At the same time the Nordic capital markets have almost fully integrated with the international capital market when all formal hindrances to capital mobility have been abolished.

It is likely that the decision to join EMU as early as possible has helped to stabilise Finnish economy and to avoid possible credibility problems related to independent monetary policy. Of course it is still too early to make any final assessments. The fact that Finland and Sweden have made different choices creates an opportunity to make comparisons later on. The experience of financial crises complicates also the question of the possible or likely implications of the EMU membership on the stability of capital markets – what will happen to asset prices, credit risks and the stability of banking system in different contingencies?

The usual argument against the use of exchange rate policy is that devaluations are useless – they do not improve exports permanently but only increase inflationary pressures. That was

exactly the argument used extensively in many European countries and also in the Nordic countries in the early 1990s in favour of fixed exchange rates and against devaluations. However, with hindsight this orthodox view does not seem to fit the facts of the Nordic recoveries in the 1990s. Contrary to the expectations the depreciations of the Nordic currencies were not followed by higher nominal wage growth or inflation as many would have predicted[6] but instead by better competitiveness. The improvement of export performance was permanent and most pronounced in Sweden and Finland.

These experiences makes one to ask what to do in similar situations if there is not possibility to use flexible exchange rates any more and when the capital markets have been fully and irreversibly liberalised. The use of currency depreciation helped especially Finland and Sweden to escape from the deflationary trap of the early 1990s which severely threatened the stability of financial system and the competitiveness of exports. If such an possibility is not any more available, how a small open economy is supposed to adjust to negative exogenous shocks? The adjustment problem is not a purely academic question. It is relevant to all Nordic countries (Denmark being a possible exception), as well as to the accession countries since in the past they have experienced different business cycle dynamics than the core countries of the euro area. This question is already central to Finland which is a member of EMU, and also important to Denmark which seeks to maintain fixed exchange rate with euro without formally joining the EMU. The question of substitutes for exchange rate flexibility was also crucial when Sweden decided to postpone her membership in the EMU.

Further integration of the European economies is likely to promote further capital market integration and capital mobility between European countries. It will most likely increase pressure for tax competition, which can threaten the financial basis of the welfare state. The Nordic countries have already responded to tax competition by lowering the corporate tax rates and taxes on capital income, but further pressures are likely to emerge with enlargement. These changes have until now been compensated by raising other taxes, and as a result, labour incomes and private consumption are heavily taxed. It is not clear how sustainable such a regime of high taxes will be in the future if mobility of goods and employees increase.

[6] That was what the Nordic central banks and governments feared in the beginning of the 1990s when they resisted the pressures to give up the fixed exchange rates although the Nordic currencies were overvalued by many measures.

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THE EVOLUTION OF THE BANKING INDUSTRY IN ITALY AND AUSTRIA AFTER THE INTRODUCTION OF THE EURO

MASSIMILIANO MARZO[1]

1 Introduction

During the past years the participation to European Union and the changeover operations represent one of the most dramatic innovations in the international landscape. The adoption of a common currency creates new challenges, especially with respect to management of monetary policy. A careful analysis if the structure of the banking system among European countries represents a very important step towards the evaluation of the transmission channel of monetary policy. In the current literature, two recent reports by Angeloni et al. (2002) and Ehrmann et al. (2001) have addressed these issues by examining the role of banking assets and liabilities and the interest rate channel as well as the credit channel for several European Countries.

In general it is possible to identify three important phenomena common to the European Banking Industry:

- Decrease of nominal interest rates during the convergence period until 2001;
- Shift of banking assets from public to private (riskier) debtors.
- Significant number of Merger and Acquisition.

In the short run the reduction in nominal interest rates was beneficial to banks, because of the capital gains associated to securities portfolios. This phenomena also increased the fraction of banks assets, because many economic agents found more convenient to open new mortgages in this period. A consequence of these aspect is the gradual shift from public debtors to private debtors of banking assets, due to important episodes of European fiscal consolidation occurred in several European countries (especially Italy).

One of the most important structural difference among the European banking industry is given by the different degree of concentration. In fact, broadly speaking we can identify three group of countries according to the different degree of concentration: countries with a concentration above 70% (SE,NL,FI,PT,DK and GR); countries with a concentration degree ranging between 40% and 60% (AT, BE, ES, IE and FR); third, a set of countries with a concentration degree

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below 30% (DE, LU, UK and IT). In general, we can observe two types of merging strategy in Europe: "strategic merger", and "defensive merger". The first strategy generally observes the presence of at least one large player and is realized with the goal of repositioning the bank within the EU market. The defensive strategy is realized with the goal if defending the bank from a possible aggressive strategy coming from another large player. The large part of mergers registered over the past 5 years in Europe have been taken place in the domestic arena, signalling an increasing effort to increase market power at the domestic level.

Overall, we can observe a general tendency in European Banks in the following phenomena: narrowing of net interest margins and a rise in non-interest income, a reduction in operating expenses and staff costs and a decline in profitability.

The creation of a single currency pushes researchers in focusing on the determinants of the mechanism of monetary transmission mechanism. The recent outset of the European Monetary Union has created a unique market with a unique, common currency, but there are large and persistent heterogeneity elements among several European Countries. To start with, we can identify some few critical elements:

1) in most European countries the bank finance is still very important with respect to other financing methods, if compared, for example with US economy. This occurred also despite the large development registered by financial markets. In fact, as reported in Table 1 it is possible to note that the banking sector is very important in Europe, much more than in US. In the literature there are many papers that analyse the relationship between the structure of the banking system and the transmission channel of monetary policy. A recent example[2] is given by Clements, Kontolemis and Levy (2001), and Ehrmann et al. (2001).

Table 1:

	EURO AREA	GERMANY	ITALY	US
Bank Total Assets	181	195	122	99
Bank Loans to Corporate Sector	45.2	39.8	49.8	12.6
Stock Market Capitalization	90	72	66	193

The amount of loans to the corporate sector for Italy is 49.8 per cent, more than three times larger than in US where it amounts to be only 12,6 per cent. Italy, in particular is above the average in the Euro Area (the last being 45,2%). This phenomena is well associated to the performance of the stock market: in Italy the stock market shows a capitalization index of 66 vs. US equal to 193. For what concerns Germany, we observe a smaller amount of bank loans to corporate sector equal to 39.8%: this is below the average on Euro area (45.2%), but still very high, if compared to US (12.6%). Again, Germany has lower market capitalization than observed in Euro Area and quite far from US. With this respect, Germany is closer to Italy. The importance of Banks in German Economy is also given by the total assets: German banks have more assets than the average in Euro Area. On average, the banking system in Euro area has more assets than in US, as it would be expected also from the amount of loans issued, which is far larger than in US.

Behind this phenomena there are structural explanations, mainly due to the legal and institutional framework characterizing each country.

2) Although the phenomena discussed before is almost an homogeneity element among European countries, in the following discussion we will try to document significant differences among banking industries and I will try to focus on those aspects which will have more impact on the transmission mechanism of monetary policy.

2 Commonalities and Differences

In many European countries only largest firms can directly issues securities on the Financial Markets. Recently there have been important changes to this. In particular, in Italy in 1999 was introduced the so called "Nuovo Mercato" aiming to help more dynamic companies (mainly those with important technological business) to access to the stock market with a simplified procedure. Despite this, the large majority of Italian firms are still heavily dependent upon the banking financing. In order to quantify this, let us look at table 2 to discover the main differences among three European Countries: Austria, Germany and Italy[3].

[2] Other interesting papers on the subject are: Mojon (2000), Favero, Giavazzi and Flabbi (1999).

[3] Germany has been included in order to make comparison between Italy, Austria and another representative country of EU.

Table 2: Non Bank Finance

	AT	IT	DE
Domestic Debt Securities issued by corporate			
As a % of GDP	1.9	0.5	0.4
As a % of bank loans to corporate sector	3.0	1.1	1.0
Stock Market Capitalization	18.5	30.6	39.9

Source: Int. Federation of Stock Exchanges, National financial Accounts

As it is shown in the above table 2 , Austria has a lower stock market capitalization if compared with Italy and Germany, but shows a larger fraction of debt securities issued by the corporate sector, which is equivalent to 3 per cent of the total of bank loans to private sector. Italy, instead, shows a fraction of 1.1 per cent over total bank loans to corporate sector. The table shows that Italian corporate sector appears to be very reluctant of issuing debt securities, different from bank credit. With this respect, Austrian system seems more dynamic if compared to Italy and Germany.

However, given the lower stock market capitalization, there is a presumption of lower liquidity of the Austrian stock market with respect to Germany and Italy. This however, remains to be further investigated. From the monetary policy perspective, this indicates that a change in credit conditions determined, for example, by a monetary policy initiative, will strongly affect firms, given their scarce opportunity to find substitutes for bank finance. Moreover, as discussed in Borio (1996) and Prometeia (2002) the large fraction of loans supplied by Italian banks are to a large extent short term loans and are issued with variable interest rates . On the other hand, in Austria, we have loans with longer maturity and with an higher share of fixed-rate contracts. The transmission of monetary policy impulses can be accelerated by short term loans with variable interest rate, like in Italy. In this case, the monetary policy channel can be further accelerated by the fact that the large fraction of Italian loans are backed by collateral: this induces the so called balance sheet channel, as carefully studied by Bernanke and Gertler (1989), Kashyap and Stein (1997). Table 3 collects few additional in formations related to Austria and Italy.

Table 3: Number of Banks and Asset Structure

	Austria	Italy
Nr. of Banks (all banks)	799	759
Average Assets		
All banks	405	1863
Large Banks	8485	28900

Sources: Eurosystem Database and Ehrmann et al. (2001).

From Table 3 we observe that Italy and Austria share a very similar number of banks, although the average asset is bigger in Italy than in Austria, given the existing differences on GDP.

From Table 4 below, I collected some in formations about the characteristics of profitability for both systems. Overall, Italian banks are more liquid than Austrian ones. Moreover, Italian banks are also better capitalized than Austrian. However, only large banks in Italy show a larger deposit share than in Austria. This is a consequence of the fragmented banking system characterizing the Austrian banking market.

Another sign of the strong dependence of the Austrian system from banking credit is given by the larger fraction of loans on total assets issued by Austrian banks with respect to Italy. So, if Italy is certainly a country where private sector still strongly depends upon banking credit, probably in Austria this represents a stronger phenomena.

Table 4: general Characteristics of banks

	Austria	Italy
Average Bank Liquidity *		
All banks	16.9	39.9
Large banks	12.7	25.7
Average Bank Capitalization *		
All banks	4.7	11.2
Large banks	3.2	6.8
Average Deposit Share *		
All banks	52.9	50.8
Large banks	22.3	34.6
Average loan Share *		
All banks	55.7	38.8
Large banks	52.9	40.5

Liquidity is defined as securities other than shares held by banks. * : percents of total assets
Sources: Eurosystem Database and Ehrmann et al. (2001).

With respect to the type of relationship lending we find several interesting aspects. The first – common to both Italy and Austria – is given by he fact that bank customers tend to establish long lasting relationships with banks. This type of relationship, however, assumes different characteristics. For what concerns Germany, for example, we have the so called house bank where firms run most of their businesses with only one bank. This is also due to the peculiarity of the universal banking model at the core of the German financial system. Austria shows a similar situation, although the model of universal bank is not operative.

Let us consider now Table 5 about market concentration and market structure. As remembered before, the past few years were characterized by an intense M&A activity among almost all European banks. Italy, in particular has been characterized by several Mergers and Acquisition. Despite this, however, Italy does not show a particularly concentrated banking sector. In fact, from Table 6 we see that the market share of the largest five banks is given by 30.1%, while only the 6 per cent of large banks have a market share of 75%.

Table 5: Market Concentration

	AT	IT	DE
Market Share of large banks (total assets =6 billions of euros)	60.5	75.0	71.7
Population share of large banks (total assets =6 billions of euros)	3.0	6.0	3.1
Herfindahl index*1000	75	29	19
Market share of largest five banks	45.3	30.1	31.5

Sources: Corvoiser and Gropp (2001), OECD and Eurosystem

This means that Italy is characterized by the presence of several banks with total assets larger than 6 billions of Euros, but that the five largest banks have only the 30 per cent of the overall market. A similar situation is for Germany, as documented in Table 2. Austria, instead, show a more concentrated market: the market share of largest five banks is 45.3 per cent, while 3 per cent of large banks own the 60.5 of the market. In the literature, this phenomena has been identified as an atomistic dimension of the German and Italian banks.

Some synthetic indicators of bank performance are reported in Table 6. From this we observe that the cost structure of the banking system across Italy, Austria and Germany is very close: In fact, for both Italy and Austria, the operating expenses occupies the 66.5 of the total income (gross of taxes). For Germany the figures are very close, too (63.5%). For what concerns the Provisions Italy seems to be in better shape with respect to both Austria and Germany, but, as shown in Table 4 the ratio of Provisions/gross income does not show any significant difference among these countries.

Table 6: Bank Performance

	AT	IT	DE
ROE	7.0	2.8	5.8
Provisions/gross income	18.3	19.1	15.4
Operating expenses/gross income	66.5	66.5	63.5

Source: OECD and Eurosystem

Some important commonalities among Italy and Austria are with respect to the presence of State in the credit market. In fact, as documented by La Porta et al. (2000), in both Italy and Austria State influence is exerted either via direct public ownership of banks (through State control) or via public guarantees. The public ownership is more important in Austria than in Italy, which recently has witnessed a large number of privatisation processes for banks. This phenomena seems to be close to the banking networks aspect. In Austria and Germany and in Northern Italy banks (especially savings banks) have established networks of various kinds. In all the three countries, banks (especially the large proportion of small banks) belong either to the cooperative sector or to the savings banks sector. The cooperative sector is very strong in the northern Italy. Both cooperative and saving sector are structures in two levels: the upper level counts banks or conglomerate service offices which serve as head institutions of their sector managing an internal liquidity service. The lower level is represented by small banks disseminated in the territory (especially rural or mountain areas) which deposits their funds in the upper level banks receiving long term loans in turn. In 1996, 750 of the 799 Austrian banks belonged to the savings bank or the credit cooperative network.

The banking system structured as cooperative or saving sector together with a large proportion of banks owned by the state casts some doubts on the effectiveness of the monetary policy channels. On one side the government presence reduces the risk of depositors and, more in general, helps to reduce the importance of asymmetric information: publicly owned or

guaranteed banks do not show strong distributional effects in their loan relations after a monetary tightening. On the other hand the network structure of banks can facilitate as a sort of insurance against the riskiness of being short of funds, during a monetary policy contraction. In fact, the head institutions of the cooperative or saving sector can play the role of liquidity providers to the lower tier. This has been especially documented by Ehrmann and Worms (2001) who show that in Germany after a monetary contraction, small banks receive a net inflow of funds from their head institutions. Moreover, in the credit cooperative sector there are frequently mutual assistance agreements which help each single bank in case of funds need as well as the importance of informational asymmetry.

All these aspects evidence that the bank size is not a good indicator for the evaluation of the distributional effects across banks. Small banks can take advantage of their role within a bank network, in order to have necessary funds to maintain their loan portfolio in monetary tightening periods.

This situation can be also confirmed by the number of bank failures: in all Euro area bank failures have occurred at a remarkable lower frequency than in US. For example, in Italy, in the period 1980-1997 over 40 banks were liquidated. In almost all cases these were small mutual banks and the share of deposits of failed banks was negligible and for only 3 out of 40 cases peaked 1%.

Deposit insurance is another commonality between Italy, Germany and Austria. In Austria insurance guarantees deposits up to 20,000 euros (1998). In Italy insurance fully covers deposits up to 103,000 euros, while the coverage is assured for 75% for deposits ranging between 103,000 and 516,000 euros. Thus, Austria has a coverage that can be defined average, while Italy has a deposit insurance coverage quite large.

Overall Italy and Austria do not seem too dissimilar countries, with respect to the structure of the banking system. A general important conclusion is about the scarce importance attributable to the size of the banking firm. The characteristics above outlined reduce the emphasis on the size, contrary to US, where size matters very much for the transmission channel, as documented by Kashyap and Stein (1995,1997,2000). The only strong difference is probably due to the recent changes occurred in Italy which shows a banking system more active and inclined to be more market oriented than in the past.

A crucial aspect of the Italian banking system is related with the large heterogeneity existing between northern and southern structure as it will be discussed in the next section.

3 The Italian Banking System during the last year

A picture of the Italian banking system during the last year cannot escape to stress the crucial heterogeneity of the market structure in across the country. Before coming to this point, however, it is worth to provide some general information about some general tendencies. The total amount of loans during 2001 showed a growth equal to 7,7%: short term loan s have increased by 6%, while medium and long term financing ahs increased of 9%. This is a positive aspect which can contribute to reduce the traditional exposure of Italian banks on short term maturities. Moreover, during the past year the overall degree of riskiness of credit has been remarkably reduced: the non-performing loans of Italian banks have been reduced of 12% with respect to 2000, and the ration of non-performing loans/total loans has been reduced to 4.7%. The tendencies on credit risk have been collected in Table 7 with regard to the branches of economic activities.

Table 7: Sector Composition of Performing and Non-Performing Loans: I

	Households	Small Firms	Non Fin. Companies	Public Sector	Others	Total
Loans	19.4	6.3	52.5	5.9	15.8	100.0
Non–Performing Loans	23.2	17.8	56.6	0.1	2.2	100.0

Source: Prometeia (2002). Numbers expressed in percentage terms.

From Table 7, we find that the largest part of non-performing loans has is attributed to Non-Financial Companies and to Households. Small firms are not riskier than large non-financial firms, as theory would suggests.

If we consider the composition of non-performing loans for branches of economic activity, as reported in Table 8, we discover that the largest portions of non performing outstanding loans is attributable to Manufacturing Firms, owing the 26.5% of total amount of non performing loans. The energy sector is probably the safest among the various other sectors of the Italian economy.

Table 8: Sector Composition of Performing and Non-Performing Loans: II.

	Agr.	Energy	Manufactures	Real Estate	Store Businesses	Others	Total
Loans	4.0	4.7	35.3	11.4	16.6	28.0	100.0
Non–Performing Loans	8.3	0.2	26.5	25.0	20.3	19.7	100.0

Source: Prometeia (2002). Numbers expressed in percentage terms.

The reduction in riskiness of the Italian credit market is mainly due to the important practice of securitization adopted by Italians banks.

With respect to profitability, we collected in Table 9 some averages returns and costs computed from 1999 and estimated for 2002. A common phenomena to be noted is a slight tendency towards the increase of average banks profitability, together with a slight increase of costs. This, helped to keep the spread between assets and liabilities returns and costs constant over time. This signals for a better conditions of banks registered during the past two years.

Table 9: Averages on returns and costs

	1999	2000	2001	2002
Average Return on Loans	6.5	6.7	7.1	6.6
Av. Cost of Provision	2.8	3.1	3.3	3.0
Spread to customers	3.7	3.6	3.8	3.6
Av. Return on bonds	4.6	5.3	4.4	4.8
Av. Return on assets (1)	5.9	6.3	6.7	6.4
Av. Cost of passive (2)	3.0	3.4	3.8	3.6
Spread (3)	2.8	2.8	2.9	2.8

Source: Prometeia (2002). (1) Active interests rate/assets; (2) Passive interest rates/Liabilities; (3)=(1)-(2).

An important characteristics of the Italian banking system is given by the large heterogeneity between the banks located in the North, Centre and South of the country. This is not necessarily linked to GDP dynamics but has very much to do with the structure of the banking industry along the country. In fact, in the South demand/supply conditions are extremely fragmented: together with the subsidiaries of largest banks (5 or 6) coexist a large number of smaller banks having only a local dimension. This is a source of very selective financing processes adopted by banks located in the south of Italy and, in many cases, of higher mark-ups on loans.

Table 10: Regional Riskiness Configuration on 2001

	IT	North-West	North-East	Centre	South	Islands
Non performing loans / total loans	4.6	2.6	2.6	4.8	4.6	16.2
Spread on Short term rates	4.3	3.9	4.5	4.3	6.2	6.1

Source: Prometeia (2002). Figures are in percentage terms.

In Table 10 are reported the ratio of non performing loans/total loans together with the average spread on short term interest rates for year 2001 for the whole country (IT), and for banks located in North-West, North East, Centre, South and Islands. The above table depicts the existence of strong differences among North of Italy and South. In particular, the north of the country show a similar riskiness situation for what concerns the ratio of non-performing loans over the total amount of loans (2.6%). Northern Italy is the area where securitization has been more effective towards the reduction of the outstanding number of non-performing loans. Centre and South of Italy show a value of this ratio close to average computed on national level. Banks located in the South show the 16.2% of total loans are non-performing loans: despite the improvements due to the securitization process, this is still a very high number, indicating an higher riskiness (on average) associated to the banking conditions in the South.

Similar considerations can be raised for the spread between short run active and passive interest rates: while banks located in the North, and Centre show to have similar spread to clientele, banks located in the South offer the worse conditions to their customers. The higher level of active interest rates practiced by banks in the south is once again a signal of the need from banks to hedge against the higher riskiness of the loan portfolio of the south.

4 Concluding Remarks

The observations collected in these pages suggest two lines of possible research. A first approach is about financial markets. Given the large heterogeneity existing between Italy and Austria, it should be interesting to evaluate the liquidity conditions characterizing both markets, This can be realized via an extensive work by applying the various liquidity measures proposed in the literature, with a special emphasis on the Bid-Ask spread and on the various components of it.

A second research avenue should concerns the analysis of monetary transmission mechanism, by abstracting from the State-level dimension. Existing studies are all realized on the banking

institutions located within a given, specified country. With a unique currency, it is feasible to expect reactions to monetary policy impulses which could be less heterogeneous across similar cross-border regions, than for heterogeneous areas within the same country. As an example, given the characteristics here described of the Austrian and Italian banking system, we should expect similar reactions to monetary impulses for banks located in the north of Italy and banks located in Austria, rather than banks located in the South of Italy. This aspect can be an important step towards the evaluation of the transmission channel of monetary policy in Europe after the introduction of the Euro.

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